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U.S. Sup. Ct.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1948

No. 83

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

vs.

MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 8, 1948

CERTIORARI GRANTED OCTOBER 11, 1948

TRANSCRIPT OF RECORD

United States Circuit Court of Appeals

TENTH CIRCUIT

No. 3542

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

MARGARET R. PHIPPS,
Respondent.

ON PETITION TO REVIEW THE DECISION OF
THE TAX COURT OF THE UNITED STATES

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THE TAX COURT OF THE UNITED STATES

Docket No. 8854.

MARGARET R. PHIPPS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Petition

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (IT: Cl: P-7 BSK-90D) dated May 3, 1945, and as a basis of her proceedings alleges as follows:

(1) The petitioner is an individual residing at 3400 Belcaro Drive, Denver, Colorado.

(2) The notice of deficiency (a copy of which is attached hereto and marked Exhibit A) was mailed to the petitioner on May 3, 1945.

(3) The Commissioner determined a deficiency in income taxes for the calendar year 1937 in the amount of $2,268.37 and the amount of income tax in controversy is $2,410.85. The return involved was filed in the office of the Collector of Internal Revenue, Denver, Colorado.

(4) The determination of tax liability set forth in said notice of deficiency is based upon the following errors:

(a) Commissioner of Internal Revenue erred in finding that dividends received by petitioner on preferred stock of The Nevada California Electric Corporation in the

amount of $18,480.00 during the year 1937 was fully subject to income tax and failed to find that 51.3405% thereof or $9,487.72 was taxfree because that portion was distributed from Capital and not from earnings or profits.

(b) The Commissioner of Internal Revenue erred in failing to find that The Nevada California Electric Corporation had a deficit in its Earned Surplus Account as of December 31, 1936.

(c) The Commissioner of Internal Revenue erred in failing to find that The Nevada-California Electric Corporation had liquidated wholly owned subsidiaries on or about December 1, 1936, that four of such liquidated subsidiaries had accumulated deficits of $3,147,803.62 which the Commissioner should have debited to the Earned Surplus Account of the parent company, The Nevada-California Electric Corporation.

(d) The Commissioner of Internal Revenue erred in omitting or excluding as deductions from Surplus Account of The Nevada-California Electric Corporation the net losses recognized upon liquidation or the net deficits of certain subsidiaries liquidated prior to 1928 in the amount of $130,939.32.

(5) The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner filed her individual income tax return for the year 1937 with the Collector of Internal Revenue in Denver, Colorado.

(b) During the year 1937 petitioner received dividends on the 2,640 shares of the 7% preferred stock of The Nevada California Electric Corporation owned by her in the amount of $18,480.00.

(c) The Nevada-California Electric Corporation had a deficit in its Earned Surplus Account on December 31, 1936, in the amount of $79,964.80. That corporation had earnings and profits for the calendar year 1937 available for distribution (excluding said debit balance) in the amount of $390,387.02. Total dividends were paid by the corporation during the year 1937 on its 7% pre-

ferred stock in the amount of $802,284.00. Such dividends were taxable to the extent of such earnings for 1937 and said dividends were taxfree to the extent of $411,896.98 being 51.3405%, which portion was paid out of neither current earnings nor accumulated earnings and profits of prior years, but out of Capital.

4 (d) The deficit to the Surplus Account of The Nevada-California Electric Corporation as of December 31, 1936, in the amount of $79,964.80 is computed by taking into account the effect of certain liquidations of subsidiaries, as follows:

(1) On or about Dec. 1, 1936, The Nevada-California Electric Corporation, being the parent company, liquidated five wholly owned subsidiaires in taxfree liquidations under the provisions of Section 112 (b) (6) of the Internal Revenue Code. Four of these subsidiaries had substantial deficits in their Earned Surplus Accounts and one had a substantial surplus as of the date of such liquidation. As a result of these liquidations the parent company's Surplus Account was reduced by the net of such deficits in the amount of $2,119,974.88, computed as follows:

	Deficits	Surplus
Cain Irrigation Co.	1,740,592.54	
Hillside Water Co.	246,575.75	
The Southern Sierras Power Co.	1,094,697.86	
Yuma Utilities Co.	65,937.47	
The Nevada-California Power Co.		
Earnings prior to March 1, 1913		937,445.97
Earnings after March 1, 1913		90,362.77
Totals	$3,147,803.62	$1,027,828.74
	1,027,828.74	
Net Deficit debited to Surplus Account by parent company	$2,119,974.88	

(2) Prior to 1928 The Nevada-California Electric Corpn., being the parent company, liquidated seven subsidiaries in exchanges upon which gain or loss was recognized. As a result of these liquidations, the parent com-

pany's Surplus Account was reduced by either the
5 net of the losses sustained thereby or the net of the earned deficits of such subsidiaries, computed as follows:

Year		Losses or Deficits	Gains or Surpluses
1917	Central California Elec. Corp.	$ 43,885.56	
1918.	Hydro-Electric Co.	5,723.80	
1919	Rialto Light, Water & Power Co.		2,753.98
"	Bishop Light & Power Co.		2,171.82
1921	Pacific Power Corp.	85,886.91	
1927	Coachilla Valley Ice & Electric Co.	11,075.11	
"	Corona Gas & Electric Light Co.		10,706.26
	Totals	$146,571.38	$15,632.06
		15,632.06	
	Net Losses or Deficits debited to Surplus Account by parent company	$130,939.32	

Wherefore the petitioner prays that your court may hear the proceeding and determine that The Nevada-California Electric Corporation had a deficit in its Earned Surplus Account as of December 31, 1936, and that dividends received by the petitioner from such corporation in the year 1937 were taxable only to the extent paid out of current earnings for such year and that 51.3405% of such dividends, amounting to $9,487.72, were taxfree and that the Commissioner erred in including such amount in petitioner's taxable income for such year, and that there is no deficiency due from petitioner for the year 1937 but that petitioner overpaid income tax for the year 1937 in the amount of $142.48.

RALPH B. MAYO
Counsel for Petitioner.

[Verified.]

Exhibit A.

7 Return Filed in Colorado

Treasury Department
Internal Revenue Service
Denver 2, Colorado

May 3, 1945

Denver
IT:Cl:R-7
(BSK-90D)

Mrs. Margaret R. Phipps
3400 Belcaro Drive
Denver 9, Colorado

Dear Mrs. Phipps:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1937 discloses a deficiency of $2,268.37, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with The Tax Court of the United States, at its principal address, Washington, D. C., for a redetermination of the deficiency or deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 918 Patterson Bldg., Denver 2, Colorado, for the attention of BSK-90D. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency or deficiencies, and will prevent the accu-

mulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Very truly yours,

Joseph D. Nunan, Jr.,
Commissioner,
By Bud E. Helvern
Internal Revenue Agent in Charge.

Enclosures:
Statement
870
Form of

Statement

Margaret R. Phipps
3400 Belcaro Drive
Denver 9, Colorado

Tax Liability for the Taxable Year Ended December 31, 1937

	Liability	Assessed	Deficiency
Income Tax	$8,922.82	$6,654.45	$2,268.37

In making this determination of your income tax liability, careful consideration has been given to the reports of examination dated July 6, 1939, and August 22, 1944; to your protests dated September 23, 1939 and September 12, 1944; to the statements made at the conference held on September 20, 1944 at the office of the Internal Revenue Agent in Charge, Denver, Colorado, and before the Western Division, Technical Staff, and to your claim for refund filed on March 10, 1941.

In your return you included in gross income the sum of $18,480.00, representing dividends received in the taxable year on preferred stock of The Nevada-California Electric Corporation. In your claim for refund it is claimed that said dividends are non-taxable under provi-

sions of Section 115(a) of the Revenue Act of 1936 as amended. In your protest of September 12, 1944, it is claimed that said dividends do not constitute taxable income to the extent of $9,487.72. It is held that said dividends constitute taxable income in their entirety. If a petition to the Tax Court of the United States is filed against the deficiency herein, the issue set forth in the claim for refund, and in the protest, should be made a part of the petition to be considered by the Tax Court in any redetermination of the tax liability. If a petition is not filed, the claim for refund will be disallowed and official notice will be issued by registered mail in accordance with Section 3772 of the Internal Revenue Code.

In your return you claim a credit for income tax paid at source in the amount of $371.38. It is held that such credit amounts to $465.48 and, accordingly, an additional credit for income tax paid at source is allowed in the amount of $94.10.

A copy of this letter and statement has been mailed to your representative, Mr. Ralph B. Mayo, 1200 Security Building, Denver 2, Colorado, in accordance with the authority contained in the power of attorney executed by you.

Year 1937

9

Adjustments to Net Income

Net Income as disclosed by Return	$41,200.84
Unallowable deductions and additional Income:	
(a) Fiduciary Income not reported	9,284.40
Total	$50,485.24
Non-taxable Income and additional deductions:	
(b) Additional contributions allowed	1,392.66
Net Income Adjusted	$49,092.58

Explanation of Adjustments

(a) It is held that the net income of the Margaret Rog-

ers Phipps Trust No. 2477A in the amount of $9,284.40 is includible in your gross income. See Phipps v. Helvering, 124 Fed. (2) 288, affirming 42 BTA 329.

(b) A deduction is allowed for contributions to the extent of 15% of the above-mentioned fiduciary income included in your gross income for the taxable year.

Year 1937

10 Computation of Tax

Net Income Adjusted		$49,092.58
Less: Personal Exemption		None
Balance (Surtax Net Income)		49,092.58
Less: Interest on Government Obligations	460.00	
Earned Income Credit (10% of $3,000.00)	300.00	760.00
Net Income subject to Normal Tax		48,332.58
Normal Tax at 4% on $48,332.58		1,933.30
Surtax on $49,092.58		7,455.00
Total Tax		9,338.30
Less: Income Tax paid at the source		465.48
Corrected Income Tax Liability		8,922.82
Income Tax Assessed: Original, account No. 200242		6,654.45
Deficiency of Income Tax		$ 2,268.37

Filed July 30, 1945.

Answer.

11 Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel,

Bureau of Internal Revenue, and for answer to the petition filed in the above-entitled proceeding admits and denies as follows:

(1) and (2). Admits the allegations contained in paragraphs (1) and (2) of the petition.

(3). Admits that the Commissioner determined a deficiency in income taxes for the calendar year 1937 in the amount of $2,268.37 and that the return involved was filed in the office of the Collector of Internal Revenue, Denver, Colorado, but denies the remaining allegations contained in paragraph (3) of the petition.

(4) (a) to (d), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (a) to (d), inclusive, of paragraph (4) of the petition.

(5) (a) and (b). Admits the allegations of facts contained in subparagraphs (a) and (b) of paragraph (5) of the petition.

(c). Denies the allegations of fact contained in subparagraph (c) of paragraph (5) of the petition except it is admitted that The Nevada California Electric Corporation had earnings and profits for the calendar year 1937 available for distribution in the amount of $390,387.02 and that total dividends were paid by the corporation during the year 1937 on its 7% preferred stock in the amount of $802,284.00.

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(d) (1) and (2). Denies the allegations of fact contained in subparagraphs (d) (1) and (2) of paragraph (5) of the petition.

Denies generally and specifically each and every allegation set forth in the petition not hereinbefore expressly admitted, qualified, or denied.

Wherefore, it is prayed that the Commissioner's determination be approved.

J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel: Orris Bennett, Division Counsel; Roy C. Hornberg, Special Attorney, Bureau of Internal Revenue.

Filed September 5, 1945.

Stipulation of Facts.

13 It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel of record, that the facts in this proceeding are as follows:

1. At all times mentioned herein, petitioner was a resident of Denver, Colorado. On or about March 15, 1938, petitioner filed with the Collector of Internal Revenue for the District of Colorado at Denver, Colorado, an individual income tax return for the calendar year 1937 disclosing a net income of $41,200.82 and a total income tax due of $6,654.45, which amount was duly assessed and was paid in quarterly installments during the year 1938 to the said Collector at Denver, Colorado.

2. During the taxable year 1937, petitioner was the owner of 2,640 shares of the seven percent $100.00 par value preferred stock of The Nevada-California Electric Corporation. Petitioner's basis for income tax purposes of each of said shares of stock was greater than the cash distributions paid by said corporation during 1937 on such stock. During the calendar year 1937 petitioner received from said corporation cash distributions on said shares of stock in the sum of $18,480.00, being $7.00 per share, which petitioner reported in full as dividend income in her return for the taxable year 1937.

3. On or before March 11, 1941, petitioner filed a claim for refund in the amount of $3,882.74 for the year 1937 on the ground that the aforesaid sum of $18,480.00 did not constitute taxable dividends. Copy of said claim for refund is attached hereto, made a part hereof and marked Exhibit A.

4. On May 3, 1945, respondent issued a statutory no-

tice of deficiency to petitioner proposing a deficiency in income tax for the year 1937 in the amount of $2,268.37, such deficiency resulting from adjustments not here in controversy. In said notice of deficiency it was stated that the dividends referred to in said claim for refund constitute taxable income in their entirety. The taxability of said dividends constitutes the only issue in controversy in this proceeding. Petitioner concedes that said dividends constitute taxable income to the extent that they were paid out of current earnings or profits of The Nevada-California Electric Corporation for the taxable year 1937, but denies that the excess of said dividends not payable out of current earnings or profits for the taxable year 1937 constitutes taxable income.

5. The earnings or profits of The Nevada-California Electric Corporation for the year 1937 were in the amount of $390,387.02. The total amount of cash distributions to stockholders by such Corporation during 1937 was $802,284.00, being distributions only to the holders of said seven percent preferred stock. The portion of such cash distributions which was payable out of current earnings or profits for the taxable year 1937 was 48.6595% ($390,387.02 ÷ $802,284.00). The portion of such cash distributions which was not paid out of current earnings or profits for the taxable year 1937 was $411,896.98, or 51.3405%

6. Of the above-described cash distribution re-
15 ceived by petitioner in the amount of $18,480.00, 48.6595%, or $8,992.28, was distributed by the corporation out of current earnings or profits for the taxable year 1937. The remainder, that is, 51.3405% of such distribution, amounting to $9,487.72, was not paid by the corporation out of current earnings or profits for the taxable year 1937.

7. On and prior to December 1, 1936, The Nevada-California Electric Corporation owned all the issued and outstanding capital stock of The Nevada-California Power Co., Cain Irrigation Co., Hillside Water Co., The Southern Sierras Power Co., and the Yuma Utilities Co. On or about December 1, 1936, each of said subsidiary corporations was liquidated by distributing all its assets, sub-

ject to its liabilities, to its sole stockholder, The Nevada-California Electric Corporation, in complete cancellation and redemption of all of its outstanding capital stock, whereupon each of said subsidiary corporations ceased to transact business and was dissolved. No gain or loss was recognized for Federal income tax purposes under the provisions of section 112 (b) (6) of the Revenue Act of 1936 on the liquidation of said five subsidiary corporations, and The Nevada-California Electric Corporation reported no gain or loss in its income and excess-profits tax returns for each year arising from said liquidations.

8. On December 1, 1936, the accumulated earnings or profits, or the deficits in accumulated earnings or profits, as the case may be, of said five subsidiary companies referred to in paragraph 7, *supra*, were as follows:

16	Deficit in Accumulated Earnings or Profits	Accumulated Earnings or Profits
Cain Irrigation Co.	1,740,592.54	
Hillside Water Co.	246,575.75	
The Southern Sierras Power Co.	1,094,697.86	
Yuma Utilities Co.	65,937.47	
The Nevada-California Power Co.		
Earnings prior to March 1, 1913		937,465.97
Earnings after February 28, 1913		90,362.77

9. As of December 31, 1936 The Nevada-California Electric Corporation had earnings or profits accumulated since February 28, 1913 in the amount of $2,129,957.81 and earnings or profits accumulated prior to March 1, 1913 in the amount of $18,060.94. Said amounts of $2,129,957.81 and $18,060.94 do not include the deficits in accumulated earnings or profits, or the accumulated earnings or profits, as the case may be, of the five subsidiary corporations referred to in paragraph 8, *supra*.

10. The Nevada-California Electric Corporation and its subsidiary corporations filed consolidated returns for the years 1918 to 1933, inclusive. The deficits and surpluses

and the earnings or losses as the case may be, of the five subsidiary corporations referred to hereinabove were not reflected in the earned surplus account on the books of The Nevada-California Electric Corporation prior to the liquidation of said subsidiary corporations on December 1, 1936, nor in the computation of earned surplus set forth in paragraph 9, *supra*.

RALPH B. MAYO,
Counsel for Petitioner.
J. P. WENCHEL,
Chief Counsel, Bureau
of Internal Revenue.

[Exhibit A of the stipulation of facts, claim for
17 refund, not designated as a part of the printed record, "since paragraph 3 of the stipulation shows that the claim was filed and the grounds thereof, and the claim itself adds no facts."]

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19 Filed May 20, 1946.

Findings of Fact and Opinion.

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8 T. C. No. 21. Promulgated January 28, 1947.

Ralph B. Mayo, C.P.A., for the petitioner.

Loyal E. Keir, Esq., and Thomas A. Steele, Jr., Esq., for the respondent.

A parent corporation in a nontaxable reorganization liquidated five wholly-owned subsidiaries, one of which had earnings and profits accumulated since March 1, 1913, in a comparatively small amount. The other four had deficits in such earnings and profits in an aggregate

amount much greater than the earnings and profits of the parent accumulated since March 1, 1913. Held, that a later distribution by the parent to its stockholders, including the petitioner, was, above the amount distributed from current earnings, distributed from capital. Commissioner v. Sansome, 60 Fed. (2d) 931; and Harter v. Helvering, 79 Fed. (2d) 12, followed.

This case involves income tax for the calendar year 1937. Deficiency was determined in the amount of $2,268.37, all of which is contested. In addition, the petitioner asserts an overpayment of $142.48. The sole issue presented is whether the petitioner is taxable upon the entire amount, or only upon a part, of a distribution made to her as stockholder of a corporation. All facts were stipulated, and we adopt the stipulation by reference and find the facts therein set forth. They may be summarized, so far as material to examination of the issue, as follows:

Findings of Fact.

The petitioner at all times pertinent was a resident of Colorado, and filed her return for the taxable year with the collector at Denver, Colorado. The return showed a net income of $41,200.82 and income tax due of $6,654.45, which was paid in 1938.

During 1937 petitioner owned 2,640 shares of preferred stock of The Nevada-California Electric Corporation, and in that year she received and reported for income tax purposes $18,480 distributions thereon. Her basis in the stock was more than the amount received in 1937. On or before March 11, 1941, she filed a claim for refund for the year 1937 in the amount of $3,882.74 on the ground that the $18,480 did not constitute taxable dividends. The deficiency notice issued May 3, 1945, held that the dividends referred to in the claim for refund constituted taxable income in their entirety. The petitioner concedes that they were taxable so far as paid out of current earnings or profits of the corporation.

The earnings or profits of the corporation for 1937 were $390,387.02. The cash distributions to stockholders during 1937 were $802,284, being distributions only to holders of preferred stock. It is stipulated that the cash distributions payable out of current earnings or profits was 48.6595 per cent and the portion of cash dis-
22 tributions not paid out of current earnings or profits was 51.3405 per cent, or $411,896.98. Of the $18,480 received by the petitioner 48.6595 per cent, or $8,992.28 was distributed out of current earnings or profits for 1937, and the remainder, 51.3405 per cent, amounting to $9,487.72, was not paid by the corporation out of current earnings or profits for 1937.

On and prior to December 1, 1936, The Nevada-California Electric Corporation owned all of the issued and outstanding capital stock of five corporations which were about that date liquidated by the distribution of all assets subject to liabilities to the sole stockholder, The Nevada-California Electric Corporation, in complete cancellation and redemption of all its outstanding capital stock, whereupon each of the subsidiaries ceased to transact business and was dissolved. No gain or loss was recognized for Federal income tax purposes on the liquidation of the five subsidiary corporations, under section 112 (b) (6) of the Revenue Act of 1936, and The Nevada-California Electric Corporation reported no gain or loss from such liquidation.

One of the liquidated corporations had on December 1, 1936, earnings or profits accumulated prior to March 1, 1913, in the total amount of $937,465.97, and accumulated earnings after February 28, 1913, of $90,362.77. The other four corporations had no accumulated earnings or profits, but had deficits totaling $3,147,803.62.

As of December 31, 1936, The Nevada-California Electric Corporation had (without including the deficits of the four liquidated corporations or the earnings or profits of the one liquidated corporation) earnings or profits accumulated since February 28, 1913, in the amount
23 of $2,129,957.81, and had earnings or profits accu-

mulated prior to March 1, 1913, in the amount of $18,060.94. It and its subsidiary corporations filed consolidated returns for the years 1918 to 1933, inclusive. The earned surplus account on its books did not reflect the deficits, surpluses, earnings, or losses of the five liquidated subsidiary corporations.

Opinion.

DISNEY, Judge: The portion of the corporate distributions by The Nevada-California Electric Corporation in 1937, not paid from current earnings or profits, was $411,896.98. The sole question here is whether that amount was paid from earnings or profits accumulated since February 28, 1913. The respondent contends, in short, that it was so paid, because Nevada Electric had at the beginning of 1937 earnings and profits accumulated since February 28, 1913, in the amount of $2,129,957.81; while, equally simply, the petitioner argues that the $2,129,957.81 was more than offset by the fact that in the liquidation of its five subsidiaries about December 1, 1936, Nevada Electric had taken over the deficits totaling $3,147,803.62, and had taken over only $90,362.77 earnings accumulated after February 28, 1913, by the one subsidiary having any earnings, leaving Nevada Electric to absorb deficits far greater than its own post-February 28, 1913, earnings, and therefore with no accumulated earnings, on January 1, 1937, out of which to distributed the $411,896.98—so that it was distributed out of capital tax free.

The issue revolves around the construction to be placed upon Commissioner v. Sansome, 60 Fed. (2d) 931; cert. denied, 287 U.S. 667. The respondent contends that case to be authority for adding to the earnings and
24 profits of Nevada Electric the accumulated earnings and profits of the one liquidated subsidiary having such. To this the petitioner agrees, but adds that it is also authority for passing to the parent corporation the deficits of the other four liquidated subsidiaries. To this the respondent objects, contending that earnings or profits of a liquidated corporation, if available for divi-

dends "*remain* available for dividends in the hands of the emerging corporation in a tax-free reorganization regardless of the operating deficits of certain of the constituent companies." Careful examination of the Sansome case is required. In that case the court, after pointing out the non-recognition features of the statute involved, providing that such "corporate transactions should not break the continuity of the corporate life," goes on:

"* * * Hence we hold that a corporate reorganization which results in no "gain or loss" under § 202 (c) (2), does not toll the company's life as a continued venture under § 201, and that what were "earnings or profits" of the original, or subsidiary, company remain, for purposes of distribution, "earnings or profits" of the successor, or parent, in liquidation. * * *"

Earlier in the opinion we find the thought: "Thus, there was income to tax as much as though the company continued its life."

In United States v. Kauffmann, 62 Fed. (2d) 1045, the court construed the Sansome case as holding that a nontaxable reorganization "was not such a change in corporate identity as prevented the new company from being considered as a continuing venture under § 201 of the Revenue Act of 1921 and that whatever were earnings of the original corporation continued to be such in the hands of the new corporation."

Baker v. Commissioner, 80 Fed. (2d) 813, involved five subsidiary corporations taken over by another in a nontaxable reorganization, and referring to the new corporation and the amount later distributed, the court said: "It had not in fact earned all of this amount itself, but *the combined taxable earnings* of itself and of the five predecessor companies made up that amount." (Italics supplied.) Harter v. Helvering, 79 Fed. (2d) 12, was by the same court, and the same judges, as the earlier Sansome case, and presents the identical question here at hand. There was in that case a nontaxable reorganization wherein two former corporations were merged into "New Company," which later was consolidat-

ed with Boxboard Co., the latter liquidating New Company and taking over substantially all of its assets. The court held that no gain was recognized in the reorganization between the two former companies and New, and said:

> * * * A consequence of this is that for purposes of allocating dividends under § 201 (b) of the Act of 1926, against earnings before and after March 1, 1913, the surplus is regarded as unchanged. * * *

Citing the Sansome case, the court proceeds:

> * * * Thus the surplus of the New Company was the difference between the assets of both the old companies and the capital shares of both, $4,307,134.34 of which only $2,085,587.78 was earned after February 28, 1913. Again when in April, 1926, the New Company consolidated with the Boxboard Company the same result ensued; for purposes of allocation the capital was $516,945 and the surplus, $4,289,745.39 of which $2,068,198.83 had been earned after February 28, 1913. * * *

Later on, referring to a distribution by Boxboard Co., it is said:

> * * * What was left was capital or earlier earnings; when the Boxboard Company took it over, it *retained this character*, and no distribution of it could be a taxable dividend. * * * (Italics supplied.)

Thus it appears that the same court which de-
26 cided the Sansome case holds that after a nontaxable reorganization "the surplus of the New Company was the difference between the assets of both the old companies and the capital shares of both"—and that the same was true in the second reorganization, between the New Company and Boxboard. Here, then, the surplus of the Nevada-California Electric Corporation consisted of the difference between the total assets of all of the old constitutent corporations, and the capital shares of all. In other words, the deficits in earnings and profits of the four subsidiaries enter into the synthesis of the

emerging surplus of the parent corporation. But if so, the deficits more than offset the earnings of both the parent and the other subsidiary which had earnings instead of a deficit. That such was the clear intent of the court is brought out by examination of the figures set forth by the court—for, as in the instant case, one of the constituent companies, in the second reorganization, to wit, Boxboard, had a deficit of $17,388.95—and "this deficit the court deducts in computing the surplus of the company resulting from consolidation of Boxboard and New Company; for, as above seen, the court computes the surplus of New Company prior to consolidation with Boxboard, as $4,307,134.34, and the surplus of the consolidated company as $4,289,745.39—less than the combined surpluses by $17,388.95. Thus it is inescapable that in that case the deficit of one company was subtracted from the surplus of the other. The respondent, on brief, in answer to petitioner's contention to the above effect, as to the Harter case, merely states that he "does not recognize such case as constituting a correct interpretation of the applicable law." Yet, the Harter case is interpretion of the Sansome case by the same court and the same
27 judges thereof, by whom the Sansome case was rendered.

This Court, in Senior Investment Corporation, 2 T.C. though in consideration of a different statute and question than herein involved, appears to indicate agreement with the principle of carrying the deficit of a merging company into the emerging company. Therein two companies were involved, Senior Investment Corporation, and Senior Corporation, formed as a part of a plan of reorganization of Senior Investment. The latter had a deficit in accumulated earnings and profits. In the nontaxable reorganization approximately two-thirds of the deficit was assumed by Senior, and about one-third retained by Senior Investment, the petitioner. The question before us was whether the petitioner was a "deficit corporation" and entitled to a credit, within the language of section 26 (c) (3) of the Revenue Act of 1936, as added by section 501 (a) (2) of the Revenue Act of 1942. We said:

* * * It is the rule that, where the assets of one corporation pass to a successor corporation in a tax-free reorganization, the accumulated earnings and profits of the old corporation pass to the successor with the same status and are available for the payment of dividends by the latter, Commissioner v. Sansome, 60 Fed. (2d) 931; certiorari denied, 287 U.S. 667; United States v. Kauffmann, 62 Fed. (2d) 1045; Reed Drug Co. v. Commissioner, 130 Fed. (2d) 288; Helen v. Crocker, 29 B.T.A. 773; and that, where only part of the assets are so transferred, it is proper to make an allocation of the earnings and profits between the two corporations in proportion to the assets transferred and the assets retained. Barnes v. United States, 22 Fed. Supp. 282; Estate of Howard H. McClintic, 47 B.T.A. 188, 202.

The respondent questions the petitioner's claim that it is a deficit corporation; but he makes no contention that the principles of the foregoing cases do not apply to the inheritance or absorption of a deficit. He questions the deficit only in two respects. * * *

The respondent's objections were to the method of dividing the deficit, and to the fact that it was computed on book values; so that his contention was that no deficit remained to the petitioner sufficient to support the credit asked. We held that regardless of which contention as to method of computation was correct, the petitioner had retained a deficit more than its later earnings and profits, so was in the taxable year a deficit corporation and was entitled to the credit sought. Thus appears recognition of offset of earnings of a reorganized corporation, by deficit prior to reorganization, for if after the reorganization, and in the taxable years the petitioner there had earnings and profits it would not have qualified for credit under the statute—yet it would have had such earnings and profits had the pre-organization deficit not been applied against them.

In Stella K. Mandel, 5 T.C. 684, we followed Senior Investment Corporation, supra, noting the "substantial identity of the old company in the several corporations in-

volved" and the "continuity of proprietary interests so as to make the rationale of the above cases applicable"—referring to the Sansome case and others relied on by the respondent in contending that "accumulated earnings and profits of a transferor corporation follow its assets in proportion thereto into the hands of a transferee on a tax-free reorganization, so as to be availble for dividend distribution." The principle was approved, despite the fact that the petitioner there was able to identify certain assets as acquired prior to 1913.

29 The respondent relies in part on Cranson v. United States, 146 Fed. (2d) 871; certiorari. denied, 326 U.S. 717. In that case a parent corporation in 1936 liquidated three wholly-owned subsidiaries, taking over their assets subject to liabilities in cancellation of the stock. The subsidiaries had an aggregate operating deficit of about $1,200,000. In the same year the parent had earnings of $931,553.82. It made a cash distribution in that year of $1.00 a share. The petitioner, a distributee, urged under the Sansome case that such earnings should be reduced by the operating deficits taken over so that he received capital, and not income. The court states that the Sansome case did not deal with the liquidation of a subsidiary, but that Regulation 94, article 115-11 recognizes the rule as applicable thereto, but did not extend the rule to embrace operating deficits, and calls the question an open one. Pointing out that whether or not the parent company suffered losses in prior years, if there were corporate earnings or profits in that year, the Revenue Act of 1936 provides that distributions to the stockholders in that year are deemed to be from most recently accumulated earnings or profits for that year, also that $931,553.82 had been earned in 1936 and undistributed profits were on hand in the amount of $139,631.26, the court approved the action of the lower court in taxing the distribution as dividends. It had earlier noted that the deficits were not shown to have occurred in 1936, and that the burden of showing error was on the taxpayer. The respondent urges that since the distribution was $1.00 a share on 937,743 shares of stock, more than the year's

earnings, the case is opposed to application of the Sansome case to deficits. The petitioner points out
30 that the amount of the distribution is not shown; and this is true. We only know that the distribution was $1.00 a share, but do not know the number of shares. It appears that in a later case, in the District Court, there was stipulation that in 1938 the number of shares outstanding was 937,743, but this does not appear in the report of the earlier case. The case is Cranson v. United States,——Fed. Supp.—— (U.S.D.C., N.D. Calif., November 12, 1943). We would not be justified in assuming such fact. Moreover, the point in the above case in the Circuit Court was whether previous inherited deficits would cut down current earnings (as is evidenced by the court's statement that the parent could not have deducted a deficit of its own), while here the sole question is as to effect of deficits on accumulated earnings or profits—the parties agreeing that so far as payable from current earnings the distribution is taxable. We do not consider the opinion in the Circuit Court as deciding the question presented to us here. The District Court decision, above referred to, for a later year, does recite a conclusion that operating deficits of subsidiaries do not diminish earnings or profits of the parent corporation otherwise available for distribution, but the facts of the case are not shown, and we may therefore not soundly predicate conclusion thereon.

After reviewing with care the above authorities we have come to the conclusion that the Sansome and Harter cases are controlling here. The primary principle announced in the Sansome case, and since consistently followed, was that a nontaxable reorganization does not toll the life of the constituent corporations as a continued venture, and it was only the result of that conclu-
31 sion to add that earnings or profits of an original or subsidiary corporation remained earnings or profits of the successor, or parent, corporation. The venture continues regardless as to whether there had been surplus or deficit in the finances of the constituent corporation; therefore, in our view, the deficit is carried for-

ward into the finances of the resultant corporation, equally with a surplus of any other constituent, and in both cases alike there is effect on the ability to distribute earnings and profits. The petitioner's corporation is merely a prolongation, in reorganized form, of a "substantial identity" of financial situation and a "continuity of proprietary interests," to use the words of the Mandel case, supra. No convincing reason appears to differentiate between surplus and deficit in the theory of continued venture. We hold that the distributions made by the parent corporation to the petitioner in the taxable year were, above the portion stipulated to be paid from current earnings, paid from capital and were not taxable dividends.

Decision will be entered under Rule 50.

Decision.

32 Pursuant to the Court's Findings of Fact and Opinion, promulgated January 28, 1947, the respondent having on March 26, 1947, filed a computation of tax, and the petitioner having on April 7, 1947, filed an acquiescence in said computation, it is

Ordered and Decreed: That there is an overpayment in income tax for the calendar year 1937 of $142.49, which amount was paid within three years before the filing of the claim for refund.

Entered April 14, 1947.

R. L. DISNEY, Judge.

Petition for Review.

3 The Commissioner of Internal Revenue, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Tenth Circuit to review the decision entered by the Tax Court of the United States on April 14, 1947, ordering and deciding that there is an overpayment in income tax for the calendar year 1937 of $142.49. This pe-

tition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the United States Internal Revenue Code.

Margaret R. Phipps, is an individual residing at Denver, Colorado, and filed her income tax return for the calendar year 1937 with the Collector of Internal Revenue for the District of Colorado located at Denver, Colorado, which collection district is within the jurisdiction of The United States Circuit Court of Appeals for the Tenth Circuit wherein this review is sought.

SEWALL KEY,
Acting Assistant Attorney General.
CHARLES OLIPHANT,
Acting Chief Counsel,
Bureau of Internal Revenue,
Counsel for Petitioner on Review.

Of Counsel: CLAUDE R. MARSHALL, Special Attorney, Bureau of Internal Revenue.

Filed July 8, 1947.

Statement of Points to be Relied Upon

37 Comes now the Commissioner of Internal Revenue, petitioner on review in the above-entitled cause, by and through his attorneys, Sewall Key, Acting Assistant Attorney General, and Charles Oliphant, Acting Chief Counsel, Bureau of Internal Revenue, and hereby states that he intends to rely upon the following points in this proceeding:

That the Tax Court of the United States erred:

1. In holding and deciding that where a parent corporation merges with its wholly owned subsidiary in a nontaxable reorganization, the "deficit" of the liquidated corporation: "is carried forward to the finances of the re-

sultant corporation, equally with the surplus of any other constituent and in both cases alike there is effect on the ability to distribute earnings and profits".

2. In failing to hold and decide that where a parent corporation merges with its wholly owned subsidiary in a nontaxable reorganization the operating deficit of the liquidated corporation is not carried forward and merged with the surplus of the resultant corporation, and accordingly does not diminish such surplus otherwise available for dividend distribution.

3. In holding and deciding in effect that when
38 the parent corporation merged with its wholly owned subsidiaries in the nontaxable liquidations and the aggregate net amount of the operating deficits of such subsidiaries were more than the amount of the earnings and profits accumulated by the parent since March 1, 1913, such deficits were carried forward to the resultant corporation and merged with its surplus and absorbed it, thereby eliminating it for otherwise available dividend distributions.

4. In failing to hold and decide that when the parent corporation merged with its wholly owned subsidiaries in the nontaxable liquidation their accumulated net operating deficits, which was in excess of the accumulated Post-1913 earnings and profits of the parent, were not carried forward to the resultant corporation and merged with its surplus and did not absorb and eliminate it for available dividend distributions.

5. In holding that the distribution made by the parent corporation to its stockholders in 1937, of which taxpayer was one, (above the portion paid from current earnings) was paid from "capital".

6. In failing to hold and decide that the distribution made by the parent corporation to its stockholders in 1937, of which taxpayer was one (above the portion paid from current earnings) was paid from available earnings and profits accumulated since March 1, 1913.

7. In holding and deciding that the distribution made

by the parent corporation to its stockholders in 1937, of which taxpayer was one, (above the portion paid from current earnings), were not taxable dividends.

8. In failing to hold and decide that the distribu-
39 tion made by the parent corporation to its stockholders in 1937, of which taxpayer was one, was a taxable dividend in its entirety.

9. In holding and deciding that the conclusions reached in the cases of Commissioner v. Sansome, 60 F. (2d) 931, and Harter v. Helvering, 79 F. (2d) 12, are controlling in the instant case.

10. In ordering and deciding that there is an overpayment in income tax for the year 1937 in the amount of $142,49.

11. In failing to order and decide that there is a deficiency in income tax for the year 1937 in the amount of $2,268.37.

12. In that its opinion and decision are not in accordance with law and the regulations and are contrary to the evidence of record.

SEWALL KEY,
Acting Assistant Attorney General.
CHARLES OLIPHANT,
Acting Chief Counsel,
Bureau of Internal Revenue.
Counsel for Petitioner on Review.

Filed July 21, 1947.

Docket Entries

1 1945

Jul. 30—Petition received and filed. Taxpayer notified. Fee paid.

Jul. 31—Copy of petition served on General Counsel.

Jul. 30—Request for hearing at Denver, Colo., filed by taxpayer. 8/2/45 Granted.

Sept. 5—Answer filed by General Counsel.

Sep. 7—Copy of answer served on taxpayer, Denver, Colorado.

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Mar. 26—Hearing set May 20, 1946, Denver, Colorado.

May 20—Hearing had before Judge Disney on merits. Stipulation as to facts filed at hearing. Petitioner's brief due 7/1/46. Respondent's brief due 7/20/46. Petitioner's reply brief due 8/5/46.

Jun. 3—Transcript of hearing 5/20/46 filed.

Jul. 1—Bhief filed by taxpayer. 7/2/46 Copy served.

Jul. 16—Motion for extension to 8/9/46 to file reply brief filed by General Counsel. 7/19/46 Granted.

Aug. 9—Reply brief filed by General Counsel.

Aug. 19—Motion for extension to Sept. 9, 1946 to file reply brief filed by taxpayer. 8/26/46 Granted.

Sep. 9—Reply brief filed by taxpayer. Copy served.

Sep. 30—Appearance of William L. Branch as counsel filed.

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Jan. 28—Findings of fact and opinion rendered, Judge Disney. Decision will be entered under Rule 50. Copy served.

Mar. 26—Computation for entry of decision filed by General Counsel.

Mar. 31—Notice of hearing 4/16/47 on respondent's motion under Rule 50.

Apr. 7—Consent to settlement filed by taxpayer.

Apr. 14—Decision entered, Judge Disney, Div. 4.

Jul. 8—Petition for review by U. S. Circuit Court of Appeals, Tenth Circuit filed by General Counsel.

Jul. 10—Notice of filing petition for review sent to Wm. L. Branch filed.

Jul. 16—Proofs of service of petition for review filed (2)

Jul. 21—Statement of points to be relied upon filed by General Counsel.

Jul. 21—Designation of portions of record proceedings and evidence to be contained in record of review filed by General Counsel.

Aug. 1—Proof of service of designation and statement of points filed.

Certificate

42 I, A. B. Cypert, acting clerk of the Tax Court of the United States, do hereby certify that the foregoing pages, 1 to 41, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Præcipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 5th day of August, 1947.

A. B. CYPERT,
Acting Clerk,
The Tax Court of the United States
EMT.

(SEAL)

Filed August 9, 1947. Robert B. Cartwright, Clerk.

And thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Tenth Circuit:

Record Entry: Cause Argued and Submitted.

Thirtieth Day, November Term, Tuesday, January 6th, A. D. 1948. Before Honorable Orie L. Phillips, Honorable Sam G. Bratton and Honorable Walter A. Huxman, Circuit Judges.

This cause came on to be heard and was argued by counsel, Harry Marselli, Esquire, appearing for petitioner, W. Clayton Carpenter, Esquire, appearing for respondent.

Thereupon this cause was submitted to the court.

OPINION

[March 10, 1948.]

Harry Marselli (Theron Lamar Caudle, Assistant Attorney General, Helen R. Carloss, Lee A. Jackson, and Helen Goodner, Special Assistant to the Attorney General, were with him on the brief) for Petitioner.

W. Clayton Carpenter (Mortgomery, Dorsey, Wm. L. Branch, and Hughes & Dorsey were with him on the brief, for Respondent.

Before PHILLIPS, BRATTON and HUXMAN, Circuit Judges.

BRATTON, Circuit Judge.

This proceeding is here on petition to review a decision of the Tax Court. Margaret R. Phipps, hereinafter referred to as the taxpayer, owned certain shares of preferred stock issued by Nevada-California Electric Corporation. On or about December 1, 1936, Nevada-California Electric Corporation, hereinafter referred to as the parent company, liquidated five wholly owned subsidiary corporations and took over their assets in complete cancellation and redemption of all of their outstanding capital stock. No gain or loss was recognized for income tax purposes on the liquidation. At the time of the liquidation, one of the subsidiaries had earnings or profits accumulated prior to March 1, 1913, in the total amount of $937,465.97, and earnings or profits accumulated after February 28, 1913, in the sum of $90,362.77. The other four subsidiaries were without accumulated earnings or profits and had deficits in the total amount of $3,147,803.62. As of December 31, 1936, the parent company had earnings or profits accumulated prior to March 1, 1913, in the amount of $18,060.94, and it had earnings or profits accumulated since February 28, 1913, in the amount of $2,139,957.81, all exclusive of the earnings or profits of the one subsidiary and of the deficits of the four. The earnings or profits of the parent company for the year 1937 amounted to $390,387.02, and the cash distributions to owners of preferred stock during the year totaled $802,284.00. Of the cash distributed $390,387.02 was paid out of current earnings or profits, and the remaining $411,896.98 was not paid out of such earnings or profits. The taxpayer received distributions during the year 1937 in the amount of $18,180.00, of which $8,992.28 was paid out of current earnings or profits, and the remaining $9,187.72 was not paid out of such earnings or profits. She seasonably reported the entire amount for income tax purposes but later filed a claim for refund on the ground that the entire amount received and reported did not constitute taxable dividends. The Commissioner of Internal

Revenue denied the claim. The Tax Court held that of the amount distributed to the taxpayer, only $8,992.28 constituted taxable dividends. The Commissioner sought review.

The question presented is whether in determining the amount of earnings or profits of the parent company available for distribution to stockholders after the liquidation of the subsidiaries, the surplus of one subsidiary should be included but the deficits of the other four excluded, or whether the earnings of the one and the deficits of the four should all be taken into account. Section 22(a) of the Revenue Act of 1936, 49 Stat. 1648, includes dividends in the definition of gross income. Section 115(a) defines a dividend for purposes of the income tax title as a distribution in money or in other property made by a corporation to its shareholders (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year, without regard to the amount of the earnings and profits at the time the distribution was made. And section 115(b) provides that for purposes of the Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. It is well settled that where one corporation acquires all of the assets of another corporation in a tax-free reorganization, the accumulated earnings or profits of the predecessor corporation are carried forward intact into the acquiring corporation as earnings or profits and are available for distribution as dividends to its stockholders, even though the acquiring corporation may have treated them as capital on its books. Commissioner v. Wheeler, 324 U. S. 542; Commissioner v. Munter, 331 U. S. 210; Commissioner v. Sansome, 60 F. (2d) 931, certiorari denied, 287 U. S. 667; United States v. Kauffmann, 62 F. (2d) 1045; Murchison's Estate v. Commissioner, 76 F. (2d) 641; Harter v. Helvering, 79 F. (2d) 12; Baker v. Commissioner, 80 F. (2d) 813; Corrigan v. Commissioner, 103 F. (2d) 1010, certiorari denied, 308 U. S. 576; Geerday Enterprises v. Commissioner, 126 F. (2d) 384; Reed Drug Co. v. Commissioner, 130 F. (2d) 288; Putnam v. United States, 149 F. (2d) 721; Crossett Western Co. v. Commissioner, 155 F. (2d) 433, certiorari denied, 329 U. S. 729.

But the Commissioner urges that the rule is limited to the treatment of accumulated earnings or profits of the company liquidated or absorbed, and that it does not include carrying forward the deficit in earnings or profits of the company liquidated or absorbed into the corresponding account of the emerged company in determining whether distributions subsequently made by the emerged company to its stockholders are made from earnings or profits or from capital. In a tax free reorganization of corporations where a parent liquidates a wholly-owned subsidiary, taking over its

assets subject to their liabilities in complete cancellation and redemption of its issued and outstanding capital stock, or where two corporations merge, the entire corporate life survives as a continued venture insofar as tax consequences are concerned. A transaction of that kind does not produce any change in respect of tax purposes, the successor being merely the continuation of the predecessor. The principle is not a narrow one, limited to accumulated earnings or profits of the liquidated or absorbed company. It includes a deficit in the earnings or profits account of such company. The earnings and profits accounts of the transferor company, whether consisting of credit balances or deficits, should be reflected in the corresponding accounts of the transferee company and should be taken into account in determining whether distributions subsequently made to stockholders of the emerged company were paid out of earnings or profits or out of capital. Harter v. Helvering, supra. The case of Cranson v. United States, 146 F. (2d) 871, certiorari denied, 326 U. S. 717, on which the Commissioner places strong reliance is not to the contrary. There the taxpayer contended that the earnings or profits of the parent company were reduced by operating deficits taken over in the liquidation of wholly owned subsidiaries, and that in consequence the distribution made to him as a stockholder in the parent company was out of capital, not earnings. But the court did not pass upon that question. Instead, it was held that in the absence of an affirmative showing that the deficits of the subsidiaries were incurred during the year in which the parent made the distribution to the taxpayer, the question was not before the court for consideration.

Conceding that prior to 1936, where a corporation had a deficit in its earned surplus account caused by operating losses, the deficit must have been restored by applying earnings subsequently received against the deficit before any of the subsequent earnings could be considered as accumulated earnings available for distribution as taxable dividend, the Commissioner urges that the rule was modified by section 115(a) of the Revenue Act of 1936, supra; and that under the provisions of that section, current earnings are available first for payment of dividends, and only the current earnings which are not distributed may be used to restore a deficit in the earned surplus account. But the only change effected by the statute was to make dividends paid out of earnings or profits of the taxable year subject to tax in the hands of the distributee without regard to the amount of accumulated earnings or profits for earlier years, and that change has no material bearing here.

The decision of the Tax Court is AFFIRMED.

Number 3542.

JUDGE HUXMAN, United States Circuit Judge, DISSENTING:

I cannot escape the conclusion that the decision of the Tax Court is wrong and should be reversed. The factual situation is set out in detail in the majority opinion and will be referred to only so far as is necessary for the purpose of this opinion. The Nevada-California Electric Corporation will be referred to as the Parent. Prior to December 1, 1936, it owned five wholly owned subsidiary corporations. One of these subsidiaries had accumulated earnings after February 28, 1913, of $90,362.77. The other four had accumulated deficits of $3,147,893.62.

These five subsidiaries were liquidated on or before December 1, 1936, in a tax-free proceeding by a surrender of all of the assets to the Parent. No gain or loss was or could be recognized as a result by virtue of Section 112(b)(6) of the Revenue Act of 1936, and the Parent accordingly reported no gain or loss as a result thereof.

At the time these subsidiaries were taken over, the Parent had no deficit in its capital structure, but on the other hand had accumulated earnings and profits of $2,129,957.81 since February 28, 1913. The question for decision is whether, when these subsidiaries came over, their net deficit in their capital structure became the deficit of the Parent to be liquidated to the extent of the accumulated earnings and profits on the books of the Parent prior to 1937, so that when such earnings of the Parent were paid out to its stockholders they would constitute a return of capital rather than a distribution of earnings.

Both parties agree that the decision is controlled by the so-called "Sansome Rule" laid down by the Second Circuit in Commissioner v. Sansome, 60 F. (2d) 931. The parties to this litigation, as well as the court, are, however, unable to agree upon the interpretation of this case.

Ordinarily, when all the stock in a company is surrendered in return for all its assets, the assets are treated as capital without distinction between accumulated earnings and ordinary corporate assets. Income tax law, however, does not treat them thus. For income tax purposes, the accumulated earnings which come over retain such status by their recipients, and when the recipient is a corporation and subsequently distributes such assets, they constitute a distribution of earnings and profits taxable as a dividend to the stockholders of such corporation. This is the Sansome Rule and is all that the court decided in that case, as I interpret it. In order to reach this result, the court held that the life of the corporation taken over does not end as to its earnings and profits, but

continues in the successor corporation, so that such accumulated earnings remain available for dividends in the hands of the successor corporation.

But it does not follow that this oneness of identity continues for all purposes. The reason for the rule is to prevent, in a tax-free transfer of all of the assets of a subsidiary, a distribution of accumulated earnings, available for dividends subject to income tax in the subsidiary's hands, from becoming capital in the hands of the Parent and thus escaping taxation as income when distributed by the Parent.

When the reason for this rule ceases, it no longer has application and the separateness of corporate entity even between a Parent and its subsidiaries applies. To hold that the separateness of identity between a subsidiary and its Parent is to be disregarded for all purposes, in a reorganization in which the Parent surrenders all the stock in return for all of the assets, so that a deficit of the subsidiary could be set up on the books of the Parent as its deficit to be wiped out by the accumulated earnings of the Parent other than earnings of the current taxable year, would allow the Parent to distribute its accumulated earnings so set off against the deficits of the subsidiaries as a return of capital—the net result would be to allow the Parent to recognize loss in the tax-free transaction and would nullify Section 112(b) (6) of the 1936 Revenue Act. Such a theory would allow the Parent, by carrying the subsidiaries' deficits into its own books, to wipe out such deficits with its own accumulated earnings and profits and thereafter to distribute such earnings and profits as a return of capital free from the income tax, when otherwise a distribution of such earnings and profits would be a dividend subject to the income tax.

The Sansome case recognizes that this does not follow. In the Sansome case, the affiliate had accumulated earnings which would be taxable if distributed by it. These earnings passed to the Parent and were subsequently distributed by the Parent to its stockholders. When the Government attempted to tax this distribution in the hands of the stockholders, it was asserted that these earnings constituted capital; but as pointed out, the Second Circuit held that for the purpose of these earnings, the separateness of the two corporations would be disregarded and the earnings would continue as such in the hands of the receiving company. The court did not, however, hold or imply that the remaining capital assets of the affiliate became the capital assets of the Parent, or that the deficit, if any, in the capital structure of the affiliate came over and became a deficit in the capital structure of the Parent which could thereafter be liquidated out of accumulated earnings of the Parent.

Thus the Court, speaking of the taxpayer, said:

> "He could not successfully assert that such dividends must be computed as part of his gain on the transaction, but must be content with a corresponding allowance when he sold. * * * The taxpayer gets his quid pro quo in the closing transaction. Though it is a riance whether the final resultant will be favorable or not, the dice are not loaded against him."

Speaking of Section 112(b) (6), the court said:

> "That section provides for cases of corporate 'reorganization' which shall not result in any 'gain or loss' to the shareholder participating in them, and it defines them with some particularity. He must wait until he has disposed of the new shares, and use his original cost as the 'base' to subtract from what he gets upon the sale."

To permit the Parent to write off the deficit in the capital structure of its affiliates as shown by their books, after the reorganization by distributing its earned surplus income to its stockholders as a distribution of capital, permits it to recognize a loss of capital in the taking over of the subsidiary at the time of reorganization without the disposal of all of tht assets taken over, without the establishment of its cost base, and in direct contravention of the applicable statutory provisions. The Sansome case is no authority for this. In fact, as I construe it, it interdicts such a result.

The majority relies in part for its position that the deficit in the capital structure of the affiliates, after they are taken over by the Parent, may be liquidated by a distribution of the Parent's earned surplus as capital, upon the case of Harter v. Commissioner, also decided by the Second Circuit 79 F. (2d) 12. But to me, that case is not in point. In the Harter case, all the subsidiaries which came over to the Parent in the reorganization had large surpluses and no deficit in their capital structure. The Parent company did have a small deficit in its capital structure. In that case, two companies, each with earned surplus, merged to form a company referred to as the New Company. The New Company later became a subsidiary of the Boxboard Company. At that time, the New Company had a large surplus both from the operation of the Sansome Rule on the earned surpluses of its predecessors and from its own activities. The stockholders of the New Company received for their stock in such company both preferred and common stock from the Parent Boxboard Company. Boxboard did not, however, take over the assets of the New Company at that time. They were sold to a third corporation for cash and stock of such third corporation. Later Boxboard bought up and retired all its preferred

stock which it had given in exchange for the stock of the New Company. In order to pay for this stock, it borrowed $3,322,987.50 from its subsidiary, the New Company. Thereafter it took over all of the assets of the New Company and cancelled its note, given for the loan, held by the New Company against its notes payable account. The only question in the Harter case was whether the accumulated surplus of the New Company came over to the Boxboard Company under the Sansome Rule at the time of the loan transaction or at the time Boxboard took over all of the assets and whether the distribution thereof was of capital or of earned surplus. Thus, the court said:

> "The question is how to allocate the payment to the Boxboard preferred stockholders made out of the proceeds of the loan by the New Company."

The court then held that the loan transaction was not a true loan but that in reality Boxboard was distributing the accumulated earnings and profits of the New Company to retire its, Boxboard's, preferred stock. It inferred from the facts that Boxboard actually took over the New Company at the time of the so-called loan, so that the Sansome Rule operated at that time to bring over the accumulated earnings as such to Boxboard and were used by Boxboard to retire its preferred stock. This, it was held, more than exhausted such surplus, and since Boxboard itself had no surplus, the later distribution had to be from capital.

Nowhere in the reasoning of the court is a deficit in the capital structure of the Parent company alluded to, nor is any statement made as to what effect that would have upon the distribution to the stockholders by the Parent of earned surplus coming to it from the subsidiary in the reorganization proceedings. It was not necessary to refer to it because it was not a point in issue in that case.

Conceding, without so holding, that a parent may liquidate its own deficit by the distribution of taxable surplus coming over to it from an affiliate or a subsidiary by distributing such surplus to its stockholders as capital, it is quite a different thing to say that it may set up the bookkeeping deficit in the affiliate or subsidiary which comes over as its own deficit without a sale of all of the assets and a determination of the exact amount of its gain or loss, and then liquidate such bookkeeping deficit now set up on its books as its own by distributing its own surplus to its stockholders as a distribution of capital.

In Commissioner v. Munter, 331 U. S. 210, the Supreme Court placed its stamp of approval on the Sansome Rule as announced in the Sansome case. It may be of some interest to note that the Harter case was not even mentioned in the opinion. Apparently

neither of the parties to that litigation attached any importance to it. Had the Harter case been urged as a modification of the Sansome Rule or had the court been of the opinion that it had a bearing on the rule, it might have well discussed it in its opinion. It appears to me that the following language by the Supreme Court is the meat in the coconut. The court says:

> "The congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part. Insofar as accumulated earnings and profits have been distributed contemporaneously with the reorganization so as to become taxable to the distributees, they, of course, cannot be said to have been acquired by the successor corporation. But insofar as payments to the predecessor corporations or their stockholders do not actually represent taxable distributions of earnings and profits, those earnings and profits must be deemed to have become available for taxable distribution by the successor corporation."

To permit a Parent company with large earned income surpluses on its books, which would be taxable if distributed by it to its stockholders, to take over affiliates with large bookkeeping deficits in a tax-free reorganization proceeding and then set up these deficits on its books as its own deficit and thereafter distribute its taxable earnings as capital to the extent of such bookkeeping deficit, in my opinion not only violates the express provisions of Section 112(b)(6), but violates the spirit of the Sansome Rule and the above quoted pronouncement by the Supreme Court.

For these reasons I am forced to respectfully dissent.

JUDGMENT

Sixty-third Day, November Term, Wednesday, March 10th, A. D. 1948. Before Honorable Orie L. Phillips, Honorable Sam G. Bratton and Honorable Walter A. Huxman, Circuit Judges.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this court that the decision of the said The Tax Court of the United States in this cause be and the same is hereby affirmed.

On April 15, 1948, the mandate of the United States Circuit Court of Appeals, in accordance with the opinion and judgment of said court, was issued to The Tax Court of the United States.

CLERK'S CERTIFICATE

United States Circuit Court of Appeals, Tenth Circuit.

I, Robert B. Cartwright, Clerk of the United States Circuit Court of Appeals for the Tenth Circuit, do hereby certify the foregoing as a full, true, and complete copy of the designated transcript of the record from The Tax Court of the United States, and full, true, and complete copies of certain pleadings, record entries and proceedings, including the opinion (except full captions, titles and endorsements omitted in pursuance of the rules of the Supreme Court of the United States) had and filed in the United States Circuit Court of Appeals for the Tenth Circuit in a certain cause in said United States Circuit Court of Appeals, No. 3542, wherein Commissioner of Internal Revenue was petitioner, and Margaret R. Phipps was respondent, as full, true, and complete as the originals of the same remain on file and of record in my office.

In Testimony Whereof, I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Tenth Circuit, at my office in Denver, Colorado, this 21st day of May, A. D. 1948.

ROBERT B. CARTWRIGHT,
Clerk of the United States Circuit Court of Appeals, Tenth Circuit.

By (S) George A. Pease
Chief Deputy Clerk.

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Supreme Court of the United States

Order allowing certiorari

Filed October 11, 1948

The petition herein for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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In the

Supreme Court of the United States

October Term, 1948

No. [redacted]

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

MARGARET R. PHIPPS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT.

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Tenth Circuit entered in this case.

OPINIONS BELOW

The opinion of the Tax Court (R. 13-23) is reported at 8 T.C. 190, and the opinion of the Circuit Court of Appeals (R. 30-37) is reported at 167 F. 2d 117.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 10, 1948 (R. 38). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The question is whether a cash distribution by a corporation during 1937 to its stockholders, of which the taxpayer received a *pro rata* share, was made from the corporation's accumulated earnings or profits, to the extent that the distribution was not covered by the current earnings for the year 1937, and was consequently taxable as a dividend under Sections 22(a) and 115(a) of the Revenue Act of 1936. The answer to this question turns on whether or not the corporation's own accumulated earnings or profits as of December 31, 1936, were eliminated by the deficits of its wholly owned subsidiaries, the assets of which were transferred in 1936 to the corporation in complete liquidations which were tax-free under Section 112(b)(6) of the Revenue Act of 1936.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations are printed in the Appendix, *infra*, pp. 16-18.

STATEMENT

All the facts were stipulated (R. 10-13) and were found by the Tax Court as stipulated (R. 14). They may be summarized as follows:

During 1937 the taxpayer, a preferred stockholder of Nevada-California Electric Corporation (hereinafter referred to as "parent corporation"), received a cash distribution on her shares in the amount of $18,480. Her cost basis, for tax purposes, for the stock was in excess of the distribution in 1937. (R. 10.)

The distribution to the taxpayer was part of a total distribution of $802,284 made *pro rata* by the parent corporation in 1937 to its preferred stockholders. The parent corporation had earnings or profits for the year 1937 of $390,387.02, and 48.6595% of the distribution in 1937 was chargeable to these earnings. (R. 11.)

On December 1, 1936, the parent corporation liquidated five of its wholly owned subsidiaries by distributing to itself all of their assets, subject to liabilities, in complete cancellation and redemption of all of their outstanding stock. No gain or loss was recognized on the liquidations for income tax purposes under Section 112(b)(6) of the Revenue Act of 1936. (R. 11-12.)

On December 1, 1936, one of the liquidated subsidiaries had earnings or profits accumulated after February 28, 1913, in the amount of $90,362.77, and the four other liquidated subsidiaries had

deficits in accumulated earnings or profits which aggregated $3,147,803.62 (R. 12).

On December 31, 1936, the parent corporation had earnings or profits accumulated after February 28, 1913, in the amount of $2,129,957.81. This amount does not include or reflect either the accumulated earnings of the one subsidiary or the deficits of the four subsidiaries, or the earnings or losses of the subsidiaries (R. 12-13).

In her income tax return for 1937 the taxpayer reported the entire amount of $18,480 distributed to her in that year as a taxable dividend but later filed a claim for refund of part of the tax paid for 1937 on the ground that the amount was not a taxable dividend (R. 10). The Commissioner determined that the distribution constituted taxable income in its entirety and so advised the taxpayer in the deficiency letter, which proposed a deficiency in income tax for 1937 resulting from adjustments not here in controversy (R. 6-7, 11).

In the Tax Court the taxpayer conceded that the distribution was a taxable dividend to the extent (48.6595%, or $8,992.28) that it was paid from current earnings for 1937[1] (R. 14). As to the

[1] Section 115(a) of the Revenue Act of 1936 (Appendix, *infra*) defines a dividend for tax purposes as a distribution by a corporation to its shareholders out of (1) its earnings or profits accumulated after February 28, 1913, or (2) the earnings of the taxable year (computed as of the close of the year), without regard to the accumulated earnings and profits at the time the distribution was made and Section 115(b) of the Act (Appendix, *infra*) declares that every distribution

balance of the distribution the Tax Court held[2] that it was not a taxable dividend paid out of the parent corporation's earnings accumulated after February 28, 1913, because all of its accumulated earnings of $2,129,957.81 as of December 31, 1936, plus the accumulated earnings of $90,362.77 of the one subsidiary, were eliminated by the deficits, aggregating $3,147,803.62, of the four subsidiaries (R. 16-23).

The Circuit Court of Appeals affirmed, Judge Huxman dissenting (R. 30-37).

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the accumulated earnings or profits of the parent corporation at the end of 1936 were extinguished, for taxable dividend purposes, by the deficits of its subsidiaries, the net assets of which the parent acquired during 1936 in tax-free liquidations of the subsidiaries.

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals is in conflict with that of the Circuit Court of Ap-

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is from the most recently accumulated earnings or profits to the extent thereof. It was therefore properly conceded that 48.6595% of the total distribution was a dividend paid from current earnings and taxable to the shareholders as such under Section 22(a) of the Revenue Act of 1936 (Appendix, *infra*).

[2] The opinion of the Tax Court written by Judge Disney was not reviewed by the whole Tax Court.

peals for the Ninth Circuit in *Cranson* v. *United States*, 146 F. 2d 871, certiorari denied, 326 U.S. 717. Although the lower court stated (R. 32) that the court in the *Cranson* case did not pass upon the question whether the deficits of subsidiaries carry over to extinguish the accumulated earnings of a parent corporation, which acquires the assets of the subsidiaries in tax-free liquidations, the record in the *Cranson* case, which was before this Court on petition for certiorari, No. 85, 1945 Term, shows that that precise point was decided by the Ninth Circuit Court of Appeals contrary to the decision of the same point by the court below.

In the *Cranson* case, pursuant to tax-free complete liquidations in 1936, a parent corporation acquired the net assets of three wholly owned subsidiaries, which together had an aggregate operating deficit of $1,205,451.61. Later in 1936 the parent made a distribution of $1 per share to its stockholders, total $937,743. (R. 38, No. 85, 1945 Term.) The parent's earnings for the year 1936 were $931,553.82 and its accumulated earnings at the beginning of the year 1936 were $139,631.26. It was there contended that the aggregate operating deficit of the subsidiaries, or alternatively the losses sustained by the parent on the liquidations (which were slightly in excess of the deficits), cancelled out both the current earnings of the parent for 1936 and its accumulated earnings at

the beginning of the year. In holding that the entire distribution of $937,743 in 1936 was a taxable dividend the Ninth Circuit Court of Appeals decided first that the parent's earnings of $931,553.82 for 1936 were not eliminated by either the deficits of, or the losses on liquidation of, the subsidiaries and thus remained as a source for payment of dividends; and second that the accumulated earnings of the parent at the beginning of 1936 were likewise not erased by the deficits of, or the losses on liquidation of, the subsidiaries and thus remained as a source for payment of the part ($6,189.18) of the total distribution which was not covered by the current earnings.[3] The latter holding is expressed in the final paragraph of the Ninth Circuit's opinion, where the court said (p. 872)—

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[3] In a subsequent case involving a distribution by the parent in 1938 this holding was reaffirmed. *Cranson* v. *United States* (N. D. Calif.), decided November 12, 1943 (32 A. F. T. R. 1640), affirmed *per curiam*, 151 F. 2d 1021 (C. C. A. 9th). The parent again distributed $937,743 in 1938, a year in which its current earnings or profits were only $695,694.64. The excess ($242,048.36) of the distribution over current earnings represented a taxable dividend only if the parent's accumulated earnings or profits survived intact after the 1936 transaction in which it had liquidated the three subsidiaries having deficits. The District Court held that neither the accumulated earnings nor the current earnings of the parent had been wiped out by the deficits of the subsidiaries or by the losses sustained by the parent upon the liquidations, and this was affirmed *per curiam* on appeal pursuant to stipulation that the final decision in *Cranson* v. *United States*, 146 F. 2d 871, certiorari denied, 326 U. S. 717, would be controlling.

> It being admitted that $931,553.82 earnings or profits were made in 1936 by the parent corporation and besides it had on hand undistributed profits of $139,631.26, the total amount exceeding that distributed to the stockholders, they were held properly by the tax court to be taxable as dividends to the distributees, of which the appellant is one. * * *

In any event, the court's holding that the entire distribution was a taxable dividend necessarily decided that the accumulated earnings were not eliminated in the transaction since the current earnings were not sufficient alone to cover the whole distribution. Further, the briefs filed in support of, and in opposition to, the petition for certiorari in this Court (No. 85, 1945 Term) argued the correctness of the Ninth Circuit's holding that the deficits of the subsidiaries did not extinguish either the accumulated or the current earnings of the parent. It follows that the Circuit Court of Appeals for the Ninth Circuit decided the same question upon substantially identical facts as is involved in this case in direct conflict with the judgment of the lower court on the question.

2. The judgment of the Circuit Court of Appeals misapplies the so-called "Sansome" principle in violation of the reasoning of this Court in *Commissioner* v. *Munter*, 331 U. S. 210. *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2), certiorari denied, 287 U. S. 667, first stated the rule, which is now firmly established (*Commissioner* v. *Munter*,

supra) that where one corporation acquires all the assets of another corporation, or corporations, in a tax-free reorganization, the accumulated earnings or profits of the predecessor corporation or corporations, which are transferred as a part of the assets, remain earnings or profits in the acquiring corporation's hands and are available for distribution as dividends by it, despite the fact that it may have capitalized the earnings on its books. The same principle applies to transfer intact to the parent corporation the accumulated earnings or profits of its subsidiary corporations, the assets of which it acquires in tax-free liquidations. *Robinette* v. *Commissioner*, 148 F. 2d 513 (C. C. A. 9); *Helvering* v. *Credit Alliance Corp.*, 122 F. 2d 361 (C. C. A. 4), affirmed, 316 U. S. 107; Article 115-11 of Treasury Regulations 101, which although promulgated under the Revenue Act of 1938 applies the rule to a distribution of assets pursuant to a liquidation made in any year. Apart from the decision in this case, however, the *Sansome* doctrine has never been held applicable to carry over, as such, the deficit of a predecessor or liquidated corporation, to a successor or parent corporation, which acquires its assets,[4] and *Cranson* v. *United*

[4] *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2) on which the Tax Court and the lower court relied (R. 17-19, 32), did not apply the *Sansome* rule to a deficit. As Judge Huxman dissenting pointed out (R. 35-36), the *Harter* case presented the typical *Sansome* situation in which corporations acquired the assets of predecessor corporations which had accumulated earnings or profits. While the Boxboard Company, which

States, *supra*, as already shown, denies that the rule applies to deficits, which of course are the antithesis of earnings or profits. There are all-persuasive reasons why the *Sansome* doctrine should not be extended to permit the inheritance of a deficit by a corporation acquiring the assets of the deficit corporation.

First, the extension of the *Sansome* rule to deficits achieves a result in conflict with the rationale of *Commissioner* v. *Munter*, 331 U. S. 210. There the Court emphasized that the *Sansome* doctrine is required to carry out the basic Congressional purpose that corporate earnings or profits are to be taxed as dividends when they are distributed. If

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acquired the assets of the new company in the final transaction in that case, itself had a deficit, the new company, the assets of which Boxboard acquired, did not have a deficit but on the contrary accumulated earnings. These earnings were held to be acquired by Boxboard as earnings and to remain earnings in its hands. It is true that these acquired earnings had to be applied to restore Boxboard's deficit before Boxboard could have any accumulated earnings available for dividend purposes (cf. 1 Mertens, Law of Federal Income Taxation, Sec. 9.30), but this merely confirms the fact that Boxboard used the acquired earnings as earnings. The situation in the present case is quite the reverse, since the parent corporation acquired the assets of corporations which were without accumulated earnings but which had bookkeeping deficits. As will be shown, these deficits (unlike the case in which the liquidated corporation has accumulated earnings) were not acquired in any sense by the parent corporation.

Cf. also *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124, petition for review dismissed February 5, 1947 (C. C. A. 6), and *Crocker* v. *Commissioner*, 20 B. T. A. 773, neither of which decided the question here.

a parent corporation is permitted to treat its own earnings as erased by the book deficits of other corporations, the assets of which it acquires, it is enabled to distribute its earnings to its stockholders without dividend tax liability, the very result which the *Sansome* rule, as applied in the *Munter* case, interdicts. An assumed continuation of the liquidated subsidiaries in the parent corporation is not alone a compelling reason for extending the *Sansome* principle to deficits, as the lower court thought (R. 31-32). The decisive factor in applying the doctrine to accumulated earnings or profits is not that the old corporation continues unchanged in the new, since the principle applies to transferred earnings or profits, even where the acquiring corporation is not a mere continuation of its predecessor (e.g., *Commissioner* v. *Munter*, *supra*; *Putnam* v. *United States*, 149 F. 2d 721 (C. C. A. 1); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6)); but on the contrary the impelling reason for the rule is in the need for preventing the disappearance of accumulated earnings in a transaction in which those earnings are not deemed to have been distributed as taxable dividends. *Commissioner* v. *Munter*, *supra*; cf. *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892.

Second, where a liquidated corporation has accumulated earnings, its assets represent capital in part and accumulated earnings, or surplus, in part.

Upon liquidation the parent corporation actually acquires the accumulated earnings in the form of property, and in order to insure taxation of the earnings as dividends upon distribution, the property so acquired is deemed to retain its character as earnings in the parent corporation's hands. *Commissioner* v. *Munter*, 331 U. S. 210. It does not, however, conform to reality to attempt to apply the same principle to deficits. Where the liquidated corporation has a deficit, none of its assets represent earnings or profits, but instead all of the assets represent its remaining unimpaired capital. Thus, the parent corporation, upon receipt of the assets on liquidation, does not acquire the deficit in the form of property, nor is the deficit transferred to the parent in an accounting sense.[5] Further, the assets acquired by the parent already constitute capital in their entirety with the result that

[5] For accounting purposes the parent receives assets and to the extent that their value might be less than the parent's investment in the stock, the parent would realize a loss, which would reduce its earnings or profits. The deficit on the subsidiary's books, as such, would not affect the parent's earnings. For tax purposes, however, any loss realized by the parent would not be recognized for tax purposes and would not reduce the parent's accumulated earnings. Section 112(b)(6), Revenue Act of 1936 (Appendix, *infra*); Article 115-3 of Treasury Regulations 94 (Appendix, *infra*); *Commissioner* v. *Wheeler*, 324 U. S. 542, rehearing denied, 325 U. S. 892. The record in this case does not show whether the parent corporation had losses or gains on the liquidation of its subsidiary corporations.

the *Sansome* rule, which operates to prevent the conversion of accumulated earnings or profits into capital in a tax-free transfer, actually has nothing upon which to operate.

Third, as Judge Huxman, dissenting, pointed out (R. 34-35), to treat a deficit as eliminating the parent's accumulated earnings would amount to an indirect frustration of the Congressional policy to postpone any recognition for tax purposes of the transaction until the assets acquired by the parent are disposed of. As already noted (fn. 5, *supra*), a loss, if any, sustained by a parent upon a complete liquidation of a subsidiary would not be deductible for tax purposes (Section 112(b)(6), Revenue Act of 1936, Appendix, *infra*) and would not be permitted to reduce the parent's accumulated earnings (Article 115-3 of Treasury Regulations 94, Appendix, *infra*; Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, which adopted the provision of the regulation for application to all prior years; *Commissioner* v. *Wheeler*, *supra*). Any such loss would, however, presumably derive wholly or in part from the fact that the subsidiary's capital had been impaired as a result of its deficits. It follows that to permit the subsidiary's book deficit to affect the earnings account of the parent would allow indirectly the deduction from the parent's earnings of all or part of the loss sustained on the liquidation, the very thing prohibited by the regulation and the subse-

quently enacted statute." In *Commissioner* v. *Wheeler*, *supra*, pp. 546-547, this Court, although concerned with a different problem, definitely rejected such a result.

3. The question in this case is an important one, which should be settled by this Court. Similar questions are presented in several cases now pending in the Tax Court and the District Courts, and the question will be a recurring one. For administrative purposes it is essential to have the proper rule declared, particularly in view of the presently existing conflict between this case and *Cranson* v. *United States*, *supra*. The administrative interest is emphasized by the fact that the decision of the Circuit Court of Appeals in this case may

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[6] Similarly, a gain to a parent corporation upon the liquidation of a subsidiary would not be recognized to it under Section 112(b)(6) and would not be reflected in the earnings account for tax purposes. Nevertheless, the *Sansome* rule operates to transfer the accumulated earnings or profits of the subsidiary to the parent as earnings. This principle, limited to earnings or profits, does not however run counter to the Congressional intent, for as pointed out in *Commissioner* v. *Munter*, *supra*, p. 215, Congress has repeatedly approved the rule in connection with earnings and in fact did so again in conjunction with enacting Section 501 of the Second Revenue Act of 1940 (H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 41, 42 (1940-2 Cum. Bull. 496, 526-527); S. Rep. No. 2114, Part 1, 76th Cong., 3d Sess., p. 25, (1940-2 Cum. Bull. 528, 546-547)) which provides that an unrecognized gain or loss should not increase or decrease earnings or profits. Furthermore, the application of the *Sansome* doctrine to accumulated earnings or profits is justified by the need of preventing tax avoidance, a consideration not present when the assets of a deficit corporation are acquired.

lead to tax avoidance. For example, a corporation having large accumulated earnings might attempt to wipe them out on paper by acquiring (presumably at nominal cost) the stock of a deficit corporation, liquidating it, and offsetting the deficit against its own earnings; it could then, in effect, seek to make a tax-free distribution of those earnings.[7]

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be granted.

PHILIP B. PERLMAN,
Solicitor General.

June, 1948.

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[7] The record in this case does not show whether the parent corporation bought the stock of the liquidated subsidiaries before any of their deficits were incurred or at some later date.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * *

(b) *Exchanges Solely in Kind.*—

* * *

(6) *Property Received by Corporation On Complete Liquidation Of Another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. * * *

* * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * *

(15) *Property Received By a Corporation On Complete Liquidation of Another.* If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112(b)(6), then the basis shall be the same as it would be in the hands of the transferor.

* * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203(a)(3) and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free

distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. * * *

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No. 83

In the Supreme Court of the United States

OCTOBER TERM, 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 83

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW.

The opinion of the Tax Court (R. 13–23) is reported at 8 T. C. 190, and the opinions in the Court of Appeals (R. 30–37) are reported at 167 F. 2d 117.

JURISDICTION

The judgment of the Court of Appeals was entered on March 10, 1948 (R. 38). The petition for a writ of certiorari was filed on June 8, 1948, and was granted on October 11, 1948 (R. 40). The jurisdiction of this Court rests on 28 U. S. C. 1254.

QUESTION PRESENTED

The question is whether a cash distribution by a corporation during 1937 to its preferred stockholders, of which the taxpayer received a *pro rata* share, was made from the corporation's accumulated earnings or profits (to the extent that the distribution was in excess of the current earnings for the year 1937) and was consequently taxable in its entirety to the stockholders as a dividend under Sections 22 (a) and 115 (a) of the Revenue Act of 1936. The answer to this question turns on whether or not the corporation's own accumulated earnings or profits as of December 31, 1936, were eliminated by the operating deficits of its wholly owned subsidiaries, the assets of which were acquired in 1936 by the corporation pursuant to complete liquidations which were tax-free under Section 112 (b) (6) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Regulations are printed in the Appendix, *infra*, pp. 68–91.

STATEMENT

All the facts were stipulated (R. 10–13) and were found by the Tax Court as stipulated (R. 14). So far as relevant, they are as follows:

During 1937, the taxpayer, the owner of 2,640 shares of preferred stock of Nevada-California Electric Corporation (hereinafter referred to as

"parent corporation"), received a cash distribution on her shares in the amount of $18,480 ($7 per share). Taxpayer's cost basis, for tax purposes, for the preferred stock was in excess of the distribution in 1937. (R. 10.)

The distribution to the taxpayer was a part of a total distribution of $802,284 made *pro rata* by the parent corporation in 1937 to its preferred stockholders. The parent corporation had earnings or profits for the year 1937 of $390,387.02, and 48.6595% of the distribution in 1937 was chargeable to these earnings. (R. 11.)

On December 1, 1936, the parent corporation liquidated five of its wholly owned subsidiaries by distributing to itself all of their assets, subject to liabilities, in complete cancellation and redemption of all of their outstanding stock. No gain or loss was recognized on the liquidations for income tax purposes under Section 112 (b) (6) of the Revenue Act of 1936. (R. 11–12.)

On December 1, 1936, one of the subsidiaries liquidated on that date had earnings or profits accumulated after February 28, 1913, in the amount of $90,362.77. The four other liquidated subsidiaries had deficits in accumulated earnings or profits which aggregated $3,147,803.62. (R. 12.)

On December 31, 1936, the parent corporation had earnings or profits which it had accumulated after February 28, 1913, in the amount of $2,129,957.81. This amount does not include or reflect

either the accumulated earnings of the one subsidiary or the deficits of the four subsidiaries, or the earnings or losses of the subsidiaries. (R. 12–13.)

In her income tax return for 1937, the taxpayer reported the entire amount of $18,480, distributed to her in that year by the parent corporation, as a taxable dividend. Later, however, she filed a claim for refund of $3,882.74 of the tax paid by her for 1937, on the ground that the distribution was not a taxable dividend. (R. 10.) The Commissioner determined that the dividend constituted taxable income in its entirety and so advised the taxpayer in the deficiency letter, which asserted a deficiency in income tax for 1937 resulting from other adjustments which were not challenged by the taxpayer in the petition filed with the Tax Court (R. 6–7, 11; 1–4).

In the Tax Court, the taxpayer conceded that $8,992.28 of the distribution was a taxable dividend since, to that extent (48.6595%), it was paid from current earnings for 1937 (R. 11, 14). The Tax Court held[1] that the balance of the distribution ($9,487.72) was not a taxable dividend paid by the parent corporation out of its earnings or profits accumulated after February 28, 1913, on the theory that all of its accumulated earnings of $2,129,957.81 on December 31, 1936, plus the ac-

[1] Judge Disney's opinion was not reviewed by the whole Tax Court, although the issue involved in the case had not theretofore been squarely decided by the Tax Court.

cumulated earnings of $90,362.77 of the one subsidiary, were erased by the aggregate deficits of $3,147,803.62 of the four subsidiaries (R. 16–23).

The Court of Appeals affirmed this holding, Judge Huxman dissenting (R. 30–37).

SPECIFICATION OF ERROR TO BE URGED

The Court of Appeals erred in holding that the accumulated earnings or profits of the parent corporation at the end of 1936 were extinguished, for taxable dividend purposes, by the deficits of its subsidiaries, the net assets of which the parent acquired during 1936 in tax-free liquidations of the subsidiaries.

SUMMARY OF ARGUMENT

Under Section 115 (a) and (b) of the Revenue Act of 1936, the cash distribution by the parent corporation in 1937 to its stockholders, of which the taxpayer as a stockholder received a *pro rata* share, was a taxable dividend in its entirety. There is no dispute that the distribution was a dividend to the extent of the parent corporation's current earnings for 1937. The remainder of the distribution also represented a taxable dividend because the parent corporation had earnings or profits accumulated after February 28, 1913, greatly in excess of the distribution, to which the distribution is chargeable. We believe that the court below erred in holding that these accumulated earnings had disappeared prior to the distri-

bution by reason of the fact that pursuant to tax-free liquidations in 1936, the parent corporation had acquired the assets of four of its wholly owned subsidiary corporations, which had deficits on their books on the date of their liquidations.

A. The so-called "*Sansome*" rule, applied by this Court in *Commissioner* v. *Munter*, 331 U. S. 210, decrees that where a corporation acquires, pursuant to a tax-free reorganization or liquidation, the assets of another corporation which has accumulated earnings or profits, the earnings of the liquidated corporation remain earnings in the hands of the acquiring corporation and are thereafter available for distribution by it as dividends. In the *Munter* case, this Court explained the *Sansome* rule as necessary to prevent the escape of the predecessor corporation's earnings from taxation as income to the stockholders upon distribution. That reason for applying the rule is absent in the case of a deficit corporation, which has no earnings which will escape tax. Instead, to permit the transfer of a deficit with the consequence that the acquiring corporation's earnings are thereby extinguished or reduced would defeat the legislative purpose, expressed in Section 115 (a) and (b), that corporate earnings are to be taxed as income upon their distribution. The *Sansome* case did not declare, as the lower court thought it did, that the corporation which acquires the assets of another corporation is a mere continuation of that corporation for all tax

purposes; the opinion merely treated the predecessor's earnings or profits as continuing as earnings in the acquiring corporation's hands.

B. Neither Congress, in enacting Section 115 (h) of the Revenue Act of 1936, 1938, and the Internal Revenue Code, nor the Treasury, in promulgating regulations which, like Section 115 (h), incorporate the *Sansome* rule, gave any indication that their references to an inheritance of "earnings and profits" carried with them the thought that deficits of predecessor corporations were also to be carried over. This is not surprising since, as a practical matter and for purposes of corporate accounting, the deficit of the acquired corporation is not, as such, transferred to the acquiring corporation. The existing deficit may cause the acquired assets to be smaller in amount than they would be but for the deficit; but only assets are acquired, deficits are not. In this respect, a situation in which *Sansome* is properly applicable is sharply distinguishable. In such a case, the transferred assets reflect accumulated earnings which do, in fact, pass to the successor corporation.

C. The losing operations of a subsidiary corporation result in a deficit from the standpoint of the subsidiary's accounting, but in a loss to the parent corporation to the extent that the assets received on liquidation by the parent have a value less than its investment in stock of the subsidiary. Under the applicable statute and regu-

lation, the parent corporation's loss, when realized in a liquidation which is tax-free, does not for tax purposes reduce its accumulated earnings or profits. The legislative mandate that a tax-free transaction is to have no effect on earnings or profits would be violated if the earnings were treated as extinguished or reduced by the deficit of the liquidated subsidiary. Moreover, the substitution of the subsidiary's deficit as a deduction from earnings, in place of deduction of the parent's loss which is prohibited by statute, unwarrantedly confuses the two separate corporations and causes the disappearance of the parent's earnings in an amount which is likely not to correspond to the loss which the parent corporation actually sustained.

It was not shown in this case that the parent corporation had a loss on liquidation of the subsidiaries or that its earnings or profits will not in the future, upon disposition of the assets acquired from the subsidiaries, reflect fully the loss on the liquidations, if any. Even if that had been shown, however, it would not warrant reduction of the earnings in 1936 by the deficit, which may be an amount quite different from the loss suffered by the parent. Taxpayer, as a stockholder, will realize any loss actually sustained by her corporation through its effect on the value of her stock, even if the loss on liquidations of the subsidiaries were never to be reflected fully in the

parent corporation's earnings account for tax purposes.

D. In more than sixteen years of litigation involving the *Sansome* rule, no decision, prior to the rulings of the courts below in this case, has extended the *Sansome* principle to treat the deficit of a liquidated corporation as reducing the accumulated earnings of the corporation which acquires its assets, and in the only cases which have directly presented such question, the Court of Appeals for the Ninth Circuit has ruled that the deficit of a liquidated subsidiary corporation is not transferred to the parent corporation which acquired its assets in a non-taxable liquidation.

E. Section 718 of the Internal Revenue Code, which defines "equity invested capital" for excess profits tax purposes, was enacted by Congress on the assumption that the deficit of a corporation which was liquidated or reorganized by another corporation would not be transferred intact to the other corporation in reduction of its accumulated earnings under the *Sansome* doctrine. This is evident from the facts (1) that Congress included no provision increasing invested capital by the amount of the deficit of a reorganized corporation, as it would be expected to have done if the deficit had theretofore reduced accumulated earnings under the *Sansome* rule; (2) that Congress directed an adjustment to invested capital to reflect the loss to a parent corporation upon the tax-free liquidation of a subsidiary corpora-

tion, which adjustment would have been an undesirable duplication, wholly or in part, of the reduction of the parent's accumulated earnings by the subsidiary's deficit if that reduction had previously occurred pursuant to the *Sansome* rule; and (3) that in Section 718 (c) (5) Congress expressly directed that in certain limited circumstances the deficit of a predecessor corporation was to carry over into the earned surplus account of the successor corporation for invested capital purposes, a statutory provision which would have been wholly unnecessary if the *Sansome* rule had operated to transfer deficits. Thus the Congressional understanding of the scope of the *Sansome* rule is at war with that of the court below. Were the decision below to stand, one of the basic factors in the computation of the excess profits tax would be distorted.

ARGUMENT

The Deficits of the Four Liquidated Subsidiaries Did Not Extinguish the Accumulated Earnings or Profits of the Parent Corporation

Introduction.—Section 22 (a) of the Revenue Act of 1936 (Appendix, *infra*, p. 68) includes "dividends" within the definition of gross income. Section 115 (a) of the Act (Appendix, *infra*, pp. 69–70) defines a dividend for purposes of the income tax title as a distribution in money or other property by a corporation to its share-

holders (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings of the taxable year (computed as of the end of the year without diminution for distributions made during the year), without regard to the amount of the earnings or profits (*i. e.*, the accumulated earnings) at the time the distribution was made.[2] Section 115 (b) (Appendix, *infra*, p. 70) provides that, for tax purposes, every distribution is made from earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits, and that only when the earnings or profits accumulated after February 28, 1913, have been distributed will a distribution be deemed to be a return of capital to apply against and reduce the stockholder's adjusted basis for his stock. The presumption as to the source of a distribution established by this Section is a conclusive one for tax purposes (*Beretta* v. *Commissioner*, 141 F. 2d

[2] Prior to Section 115 (a) of the Revenue Act of 1936, a dividend was defined for general income tax purposes as a distribution out of earnings or profits accumulated after February 28, 1913. See, *e. g.*, Section 115 (a), Revenue Act of 1934, c. 277, 48 Stat. 680. The definition of dividend was changed in 1936 to enable all corporations to obtain a dividends-paid credit by distributing the current year's earnings, for purposes of computing the surtax on undistributed profits imposed on corporations by Section 14 of the Revenue Act of 1936, without regard to whether a deficit existed in the earned surplus account at the beginning of the year. S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18 (1939-1 Cum. Bull. (Part 2) 678, 689).

452, 455 (C. C. A. 5th), certiorari denied, 323 U. S. 720; S. Rep. No. 275, 67th Cong., 1st Sess., p. 10 (1939-1 Cum. Bull. (Part 2) 181, 187)), with certain exceptions made in later subsections of Section 115.[3] In accordance with these statutory provisions, the taxpayer properly conceded in the Tax Court (R. 14) that the distribution in cash by the parent corporation to its stockholders in 1937 was a taxable dividend to the extent (48.6595%) that it was covered by the current earnings for 1937.

The only question in this case is whether the $411,896.98 (51.3405%) of the distribution, which was in excess of the current earnings, constituted a taxable dividend. This, in turn, under Section 115 (a) and (b), depends on whether, at the time of the distribution, the parent corporation had earnings or profits accumulated after February 28, 1913, equal to, or in excess of, that amount. At the beginning of the year 1937, the parent corporation had earnings or profits accumulated by it after February 28, 1913, in the amount of $2,129,957.81 (R. 12), which was greatly in excess of the $411,896.98 distributed

[3] Section 115 (c) of the Revenue Act of 1936 provides that distributions in liquidation are to be treated as payments in exchange for the stock and, in the case of a distribution in partial liquidation, the part that is properly chargeable to capital account shall not be considered a distribution of earnings or profits. Section 115 (h) (Appendix, *infra*, pp. 70-71) directs that earnings or profits are not to be considered as distributed by a distribution upon which gain is not recognized by law, or which is a non-taxable stock dividend.

in 1937 which is in dispute here. The conclusion seems therefore to be required, under Section 115 (a) and (b), that the entire distribution is taxable as a dividend to the stockholders of the parent corporation. Cf. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283.

The courts below (R. 30–32; 16–23) held, however, that under the so-called *Sansome* doctrine, the accumulated earnings of the parent corporation were eliminated in their entirety, for dividend purposes, by the deficits, aggregating $3,147,803.62, of four of the five subsidiaries which were liquidated in 1936, and, accordingly, that the 1937 distribution, to the extent of $411,896.98, was from capital.

In *Commissioner* v. *Munter*, 331 U. S. 210, this Court approved and applied the principle, first stated in *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, and since firmly established,[4] that where a cor-

[4] *United States* v. *Kaufmann*, 62 F. 2d 1045 (C. C. A. 9th); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5th); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d); *Geerday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4th); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Putnam* v. *United States*, 149 F. 2d 721 (C. C. A. 1st); *Crossett Western Co.* v. *Commissioner*, 155 F. 2d 433 (C. C. A. 3d), certiorari denied, 329 U. S. 729; *Barnes* v. *United States*, 22 F. Supp. 282 (E. D. Pa.); *Riverside Cement Co.* v. *Rogan*, 59 F. Supp. 401 (S. D. Cal.); *Crocker* v. *Commissioner*, 29 B. T. A. 773; *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188; *Mandel* v. *Commissioner*, 5 T. C. 684.

poration transfers all or a part of its assets to another corporation in a tax-free reorganization, the accumulated earnings or profits, included in the assets transferred, do not lose their status as earnings or profits in the hands of the acquiring corporation and are available for distribution as dividends by it, despite the fact that for bookkeeping or other purposes the acquired earnings may be treated as capital of the acquiring corporation.[5] The same principle applies to preserve the accumulated earnings or profits of subsidiary corporations as earnings in the hands of the parent corporation which acquires the assets of the subsidiaries in complete liquidations, on which gain or loss is not recognized for tax purposes. *Robinette* v. *Commissioner*, 148 F. 2d 513 (C. C. A. 9th); *Helvering* v. *Credit Alliance Corp.*, 122 F. 2d 361, 364–365 (C. C. A. 4th), affirmed, 316 U. S. 107; Art. 115–11 of Treasury Regulations 101 (Appendix, *infra*, pp. 89–91) which, although promulgated under the Revenue Act of 1938, applies the rule to a distribution of the subsidiary's assets pursuant to a tax-free liquidation made in any year. Under this latter principle, both parties correctly agreed in the Tax

[5] The operation of the *Sansome* rule is restricted to the accumulated earnings which cannot be deemed, for tax purposes, to have been distributed by the corporation, which transferred its assets, to its stockholders in the course of the reorganization. *Commissioner* v. *Munter*, 331 U. S. at 215–216; *Campbell* v. *United States*, 144 F. 2d 177, 181–182 (C. C. A. 3d); *Slover* v. *Commissioner*, 6 T. C. 884.

Court (R. 16) that the accumulated earnings, in the amount of $90,362.77, of the one subsidiary remained earnings in the hands of the parent corporation upon its acquisition of all of the subsidiary's assets in complete liquidation on which gain or loss was not recognized under Section 112 (b) (6) of the Revenue Act of 1936 (Appendix, *infra*, p. 69).

The four other liquidated subsidiaries, however, did not have any earnings or profits to which the *Sansome* rule might apply. Nevertheless, the taxpayer's argument, which both lower courts adopted, is that the doctrine, which was developed judicially with the object of preserving a liquidated corporation's "earnings or profits" so that they might be taxed upon distribution as dividends, may be expanded in this case to transfer the deficits of the liquidated subsidiaries with the result that the accumulated earnings of the parent corporation otherwise available for distribution as dividends, vanished. It is the Government's view that adoption of this argument works a distortion of the *Sansome* principle.

A. *Application of the* Sansome *rule to permit a parent corporation to inherit the deficits of its subsidiaries runs counter to the purpose of that rule to prevent tax avoidance.*—In *Commissioner* v. *Munter*, 331 U. S. 210, this Court explained the reason for the *Sansome* rule as follows (pp. 214–216):

A basic principle of the income tax laws has long been that corporate earnings and profits should be taxed when they are distributed to the stockholders who own the distributing corporation. * * * Thus unless those earnings and profits accumulated by the predecessor corporations and undistributed in this reorganization are deemed to have been acquired by the successor corporation and taxable upon distribution by it, they would escape the taxation which Congress intended. * * *

In *Commissioner v. Sansome, supra,* it was held that implicit in the tax exemption of reorganization distributions was the understanding that the earnings and profits so exempt were acquired by the new corporation and were taxable as income to stockholders when subsequently distributed. * * *

* * * * *

The congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part. Insofar as accumulated earnings and profits have been distributed contemporaneously with the reorganization so as to become taxable to the distributees, they, of course, cannot be said to have been acquired by the successor corporation. But insofar as payments to the predecessor corporations or their stockholders do not actually represent taxable distributions of

> earnings and profits, those earnings and profits must be deemed to have become available for taxable distribution by the successor corporation.

The purpose of the *Sansome* rule to prevent tax avoidance was recognized by the Court of Appeals for the Fifth Circuit in one of the earliest of the many cases that have applied the *Sansome* principle when, in *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642, that court said:

> Unless the undistributed gains of the old business are taken over by the new as undivided profits distributable as dividends, they escape proper taxation.

And the matter was shortly put more recently when the Court of Appeals for the First Circuit said: "The purpose of the *Sansome* rule is to prevent tax evasion." *Putnam* v. *United States*, 149 F. 2d 721, 726. See also *Slover* v. *Commissioner*, 6 T. C. 884, 886.

That the origin and impelling reason for applying the *Sansome* rule is found in the necessity for obviating tax avoidance is forcefully high-lighted by the fact that where the liquidated corporation distributes a taxable dividend, covering its earnings, in the course of the reorganization, the rule has no application. *Commissioner* v. *Munter*, *supra*; *Campbell* v. *United States*, 144 F. 2d 177, 181–182 (C. C. A. 3d); *Slover* v. *Commissioner*, *supra*.

The reason for invoking the doctrine is absent where the liquidated corporation has a deficit. In such a case, there is no danger that a book capitalization of earnings will make possible an untaxed distribution of those earnings. Indeed, the extension of the *Sansome* rule to deficits would permit tax avoidance, the precise thing the rule was formulated to prevent. If, upon the acquisition of the assets of a corporation which formerly had a deficit, the acquiring corporation's earnings are treated as having been eliminated or reduced to the extent of the former deficit, the successor will be put in a position to distribute its own earnings to its stockholders without their being required to report them as taxable dividends as Section 115 (a) and (b) requires. This result would plainly frustrate the Congressional purpose, expressed in Section 115 (a) and (b), to tax distributions of corporate earnings or profits as they occur.[8] It cannot be justified by a doctrine the purpose of which was to prevent just such a result.

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[8] This circumvention of the Congressional purpose would occur in every case in which the liquidated corporation had a deficit which was treated as reducing the earnings of the acquiring corporation, and not merely in those cases in which the acquiring corporation purchased the stock of a deficit corporation for the express purpose of acquiring the deficit upon liquidation for tax avoidance purposes on the part of its stockholders. In the latter case, it might well be held, under the reasoning of *Gregory* v. *Helvering*, 293 U. S. 465, and *Bazley* v. *Commissioner*, 331 U. S. 737 (and cf. Section 129 of the Internal Revenue Code, as added by Section 128

Both lower courts in this case disregarded the underlying purpose of the *Sansome* rule and took the view (R. 22–23, 31–32) that the principle is equally applicable whether the liquidated corporation had accumulated earnings or a deficit, on the theory that in a tax-free transaction the corporate existence of the liquidated corporation is deemed to continue in the corporation which acquires its assets for all tax purposes. But the *Sansome* case, even taken alone and particularly when considered with the other decisions applying the same principle, does not support the statement of the Court of Appeals that in a liquidation or merger (R. 32)—

> * * * the entire corporate life survives as a continued venture insofar as tax consequences are concerned. A transaction of that kind does not produce any change in respect of tax purposes, the successor being merely the continuation of the predecessor. The principle is not a narrow one, limited to accumulated earnings or profits of the liquidated or absorbed company. * * *

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of the Revenue Act of 1943, c. 63, 58 Stat. 21 (26 U. S. C. 1946 ed. Sec. 129)), that the entire transaction had no substance and would be given no effect for tax purposes. Even so, it cannot be gainsaid that the decision below offers an additional incentive for attempts at tax avoidance by use of the reorganization provisions of the Internal Revenue Code and thus creates an additional risk of loss to the revenues.

The record in this case does not, of course, show whether the parent corporation acquired the stocks of the subsidiary companies before or after they had incurred their deficits, nor does it show the purpose of the acquisitions.

As Judge Huxman, dissenting, understood (R. 34), it has not been held that the oneness of identity continues for all tax purposes and in a situation where the reason for the *Sansome* rule ceases, it should no longer be given application.

In *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, Judge Learned Hand did refer to the fact that the reorganization there did not break the continuity of the corporate life, but that was not the basis of the decision. In the *Sansome* case, the new corporation could accurately be termed a continuation of the old corporation, since it continued in the same business with the same stockholders and assets. But as stated by the Second Circuit (p. 933), the basis of the decision was that Section 202 (c) (2) of the Revenue Act of 1921, c. 136, 42 Stat. 227 (which provided for the non-recognition of gain or loss on the exchange of stock or securities of one corporation for stock or securities in another corporation pursuant to a reorganization to which both corporations are parties), must be read as a gloss upon Section 201 of the Act (which defined a dividend as any distribution by a corporation out of its earnings or profits accumulated since February 28, 1913, and provided *inter alia* that every distribution is made from the most recently accumulated earnings or profits); and that, when so read, a reorganization from which gain or loss did not result did not "toll the company's life as a continued venture

under section 201" (Italics supplied) and therefore should not be treated for tax purposes as converting accumulated profits into capital. Hence, the decision was reached "as a matter of statutory construction" (p. 933) and the court treated the venture as continuing *only for purposes of Section 201, i. e.*, as continuing the accumulated profits as profits in the hands of the successor corporation.

This reading of the *Sansome* opinion is plainly confirmed by this Court's recent decision in *Commissioner* v. *Munter*, 331 U. S. 210. In that case, the Court of Appeals for the Third Circuit had, in reliance upon its previous decision in *Campbell* v. *United States*, 144 F. 2d 177, refused to apply the *Sansome* rule on the ground that, there not being an identity of proprietary interests in the predecessor and successor corporations, the continuity of corporate life had been broken. This Court squarely rejected that approach; as has been noted (*supra*, pp. 15–17), it held that the essence of the *Sansome* principle was the prevention of an untaxed distribution of earnings and that the lack of identity between the old and new corporations was of no consequence. This is an inescapable demonstration that the *Sansome* rule does not depend on a real or assumed oneness of corporate identity and consequent "continuity," a conclusion which had been foreshadowed not only by

the lower federal courts but by this Court itself.[8]

B. *The legislative and administrative confirmation of the principle announced in the* Sansome *case did not extend that principle to embrace the inheritance of deficits which, as a practical matter, are not transferred in the course of a reorganization or liquidation.*—Section 115 (h) of the Revenue Act of 1936 (Appendix, *infra*, pp. 70–71) provides in substance that distributions of stock or securities made by a corporation at any time shall not be considered a distribution of earnings or profits of any corporation, if no gain was recognized by law to the distributee on the receipt of the stock or securities, or if the distribution was a non-taxable stock dividend in the hands of the distributee. In recommending the section in the form in which it was enacted, the Senate Finance Committee said (S. Rep. No.

[7] *Putnam* v. *United States*, 149 F. 2d 721 (C. C. A. 1st); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Crocker* v. *Commissioner*, 29 B. T. A. 773.

[8] In *New Colonial Ice Co.* v. *Commissioner*, 66 F. 2d 480 (C. C. A. 2d), affirmed *sub nom. New Colonial Co.* v. *Helvering*, 292 U. S. 435, the court expressly pointed out (p. 482) that the *Sansome* case was limited to transactions falling within Sections 201 and 202. Both it and this Court held that a new corporation was a different entity from the old corporation, the assets of which the new corporation acquired in exchange for some of its stock which was distributed to the old company's stockholders; and that the new corporation could not carry over and deduct the old company's net losses for the preceding tax period under a statute which permitted a taxpayer to deduct a net loss for one year on his return for the succeeding taxable year.

2156, 74th Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690)):

SECTION 115 (H). EFFECT OF DISTRIBUTIONS ON EARNINGS AND PROFITS

The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a nontaxable stock dividend or a distribution of stock or securities in connection with a reorganization or other exchange, *on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.* This rule is stated only in part in section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner* v. *Sansome* (60 Fed. (2d), 931); *United States* v. *Kauffman* (62 Fed. (2d), 1045); *Murchesson* v. *Comm.* (76 Fed. (2d), 641). While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity. [Italics supplied.]

The italicized part of this committee report was carried over substantially verbatim into Article 115–11 of Treasury Regulations 94 (Appendix, *infra*, p. 89), promulgated under the Revenue Act of 1936.

Section 115 (h) of the Revenue Act of 1938 (Appendix, *infra*, p. 71), amended the 1936 section so that it applied to distributions of "property or money" in addition to distributions of "stock or securities"[9] and as thus amended the secton was continued in the Internal Revenue Code as Section 115 (h) (26 U. S. C. 1946 ed., Sec. 115). Article 115–11 of Treasury Regulations 101 (Appendix, *infra*, pp. 89–91), promul-

[9] S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792), explained the amendment as follows:

"Under existing law, distributions of any property by a corporation which under the provisions of section 112 (b) or (c) are received by the shareholder without the recognition of gain to him (irrespective of what basis the property takes in the hands of such shareholder) are not regarded as being in any respect distributions of earnings or profits. Consequently, such earnings or profits remain unimpaired out of which taxable dividends may subsequently be declared either by the corporation making the distribution or by another corporation which, as to property acquired in an exchange described in section 112, takes in whole or in part the transferor's basis, so that the earnings or profits of the transferor corporation become in whole or in part the earnings or profits of such other corporation.

"In view of the fact that sections 112 (b) (6) and (7) permit the distribution of property (including money), in addition to stock or securities, without the recognition of gain to the distributee, appropriate changes are made in section 115 (h) of the House bill in the interest of added clarity."

gated under the Revenue Act of 1938, was amended to conform to this statutory change. The corresponding sections of subsequent Regulations were substantially the same.[10]

As this Court recognized in *Commissioner* v. *Munter*, 331 U. S. 210, 215, Section 115 (h) and the regulation both incorporate and follow the *Sansome* doctrine. The statute and the regulation, as well as the committee reports, quoted above, explaining the statute, refer only to "earnings or profits" and use the term in connection with amounts which are to be considered as available for distribution as dividends in the income tax sense following transactions of a non-taxable character. Obviously, in this context, there is no basis for an inference that the term was understood as including a deficit, since under Section 115 (a), a deficit is not a source for dividends.[11] Cf. *Cranson* v. *United States*, 146 F. 2d 871 (C. C. A. 9th), certiorari denied, 326 U. S. 717,

[10] Section 19.115–11 of Treasury Regulations 103 and Section 29.115–11 of Treasury Regulations 111, both promulgated under the Internal Revenue Code.

[11] The suggestion has been made that the term "earnings or profits" can be construed as referring to the "earned surplus account" and that in this sense it would include a negative balance (a deficit) in the account, as well as a positive balance, or earnings. But the statute, the regulation, and the committee reports were dealing with the earnings or profits available for dividends for tax purposes and were in no way concerned with the accounting aspect of the question. Moreover, it seems obvious that if the earned surplus account had been meant, that term would have been used.

where the court stated (p. 871) that Article 115–11 of Treasury Regulations 94 did not extend the rule to embrace operating deficits.

That Congress and the Treasury have made no mention of a deficit transfer in their discussions of the *Sansome* rule is not surprising in view of the practicalities of a reorganization or liquidation of a corporation with an operating deficit. Where a corporation has accumulated earnings or profits, they appear as such on the liability and net worth side of the balance sheet, but they are also represented by some part of the assets carried on the asset side of the balance sheet. The total assets together reflect and balance off the corporation's liabilities to creditors, its capital stock account, its paid-in surplus if any, and its accumulated earnings and profits. Stated another way, the total assets exceed the liability, capital stock, and capital surplus accounts in the amount of the accumulated earnings. Cf. *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215. Hence, when such a corporation transfers all of its assets to a new or parent corporation, it necessarily transfers assets representing its accumulated earnings, and the acquiring corporation in fact receives the earnings in the form of property. The *Sansome* rule declares that for tax purposes these assets must retain their character as earnings in its hands instead of being capitalized, in order not to thwart the Congressional purpose that earn-

ings shall be taxed as dividends when distributed. *Commissioner* v. *Munter*, 331 U. S. 210.

On the other hand, where a corporation has a deficit instead of accumulated earnings or profits, none of its assets include or represent the deficit. The assets are less than its liabilities to creditors and to the holders of its capital stock; and to the extent of the deficit its capital is impaired. Cf. *United States* v. *Ogilvie Hardware Co.*, 330 U. S. 709, 711; *Willcuts* v. *Milton Dairy Co.*, *supra*. Consequently, the parent or successor corporation, upon acquisition of the assets, does not receive any assets which include or reflect the deficit; the assets received, to the extent that they are not subject to liabilities, reflect merely the capital stock. Thus, the acquiring corporation does not in fact acquire the deficit in any form. The deficit is the result of a reduction in, or loss of, assets in the past, and although the assets transferred upon the corporation's liquidation are less than they would have been had the liquidation taken place before the deficit was incurred, the assets actually transferred in liquidation are as of that date not reduced or affected in any way by the previously incurred deficits.

It follows that it would be illogical and unrealistic to treat the liquidated corporation's deficit as passing to the successor or parent corporation. Assets are transferred but, in contrast to the situation where the liquidated corporation had accumulated earnings, none of the assets reflect

the deficit. There is thus no factual basis for treating the transaction as though the acquiring corporation had taken over the deficit. Indeed, even for accounting purposes, a deficit is not regarded as transferred to a corporation which acquires the deficit corporation's assets,[12] although this, of course, is not controlling for federal tax purposes (*Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892).

Finally, as we have said, the *Sansome* rule is a device to prevent the earnings or profits of a predecessor, which are included in transferred assets, from being transformed into capital in the acquiring corporation's hands for taxable dividend purposes. But since in the case of a deficit corporation all of the net assets transferred by it already represent capital in its hands, there are actually no earnings upon which the *Sansome* rule can operate to prevent their transformation into capital.

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[12] To the extent that the assets received upon liquidation are less than the acquiring corporation's investment in the stock of the liquidated corporation, the former would sustain a loss, and for accounting purposes its earnings would be reduced by the *loss* on the liquidation. Although the operating deficit may be responsible wholly or in part for the loss, if any, the deficit itself, as such, would not reduce the earnings of the acquiring corporation. As will be shown, *infra*, pp. 29–40, for tax purposes as distinguished from accounting purposes, the loss is not permitted to reduce earnings and a reduction for the loss should not be allowed indirectly through subtraction of the former corporation's deficit.

C. *Application of the* Sansome *rule to permit the inheritance of a deficit would frustrate the explicit Congressional direction that unrecognized losses not reduce earnings.*—The capital account of a subsidiary corporation which has incurred a deficit as a result of its past operations is impaired in the amount of the deficit. Whether the impairment of capital as shown on the subsidiary's books will affect the parent corporation owning its stock depends on the amount of the parent's investment in the stock. If, upon liquidation of the subsidiary or other disposition of its stock, the parent receives assets of a lesser fair market value than its cost basis for the subsidiary's stock, it will suffer a loss to the extent of that difference. Section 111 (a) and (b), Revenue Act of 1936 (Appendix, *infra*, p. 68). But only if the parent's cost basis for the stock were exactly equal to the capital account as stated on the subsidiary's books and only if the value of the assets received by the parent were exactly equal to the value at which they were carried in computing the subsidiary's deficit, would the parent's loss correspond in amount to the deficit of the subsidiary. In most cases, the amounts of the deficit and the loss, if any, will not be the same, although both result from the subsidiary's previous unsuccessful operations. Such operations have produced a result, which from the standpoint of the subsidiary is a deficit,

and from the standpoint of the parent corporation may be a loss on its stock investment.

The record in this case does not show whether or not the parent corporation had a loss on the complete liquidation of any of the four subsidiaries. If losses were realized, however, they would not be recognized as deductible for tax purposes under Section 112 (b) (6) of the Revenue Act of 1936. And Article 115–3 of Treasury Regulations 94 (Appendix, *infra*, p. 87) states significantly that—

> Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

This regulation is reasonable and valid (see *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892), and its provisions were incorporated into the Internal Revenue Code as Section 115 (l) and made applicable to all prior years by Section 501 of the Second Revenue Act of 1940 (Appendix, *infra*, pp. 72–74). See also *Commissioner* v. *Fisher*, 327 U. S. 512.

Consequently, even if it is assumed without proof that the parent here had losses on the liquidation of the four subsidiaries which had deficits, its losses would not be permitted to reduce in any amount its earnings or profits for tax purposes, although they would perhaps do so

for bookkeeping purposes. Cf. *Commissioner* v. *Wheeler*, 324 U. S. at 546–547. And if the losses could not be used to eliminate the earnings, it would frustrate the legislative intention in that respect to permit a reduction of the parent's earnings by the subsidiaries' deficits. Thus, if the parent corporation had been granted the right by Congress to reduce its earnings by its loss on the liquidations, there could obviously be no contention that the deficits of the subsidiaries should also reduce its earnings. By the same token, to deduct the deficits is to substitute a compensating deduction for the deduction withheld by Congress and the regulation. The decision of the court below permitting the subsidiaries' deficits to wipe out the parent's accumulated earnings thus accomplishes indirectly that which is expressly prohibited by the regulation and the subsequently enacted statute.

The subsidiary's deficit *as such* should not reduce the parent's earnings, since the subsidiary's deficit is merely the measure from its viewpoint of its previous unprofitable operations; these operations are properly reflected, so far as the parent is concerned, only in the parent's loss. Thus, the attempt to deduct the subsidiaries' deficits from the parent's earnings, in circumvention of the legislative denial of the right to deduct the parent's own loss, is a wholly unwarranted confusion of the effect of the losing operations of the subsidiaries on the subsidiaries them-

selves with their separate and more indirect effect on the parent corporation. Cf. *New Colonial Co. v. Helvering*, 292 U. S. 435; *Interstate Transit Lines v. Commissioner*, 319 U. S. 590; *Moline Properties v. Commissioner*, 319 U. S. 436; *Commissioner v. National Carbide Corp.*, 167 F. 2d 304 (C. C. A. 2d), pending on certiorari, Nos. 151–153, this Term.

To reduce the parent's earnings by the subsidiaries' deficits is to assume, moreover, that the deficits must necessarily correspond in amount to the parent's actual loss. But this assumption is unwarranted, as has been shown, *supra*, pp. 29–30. As an example, the parent corporation may have purchased stock of a subsidiary, after all or a part of its deficit has been incurred, at a price equalling the value of the remaining assets. The parent would then sustain little or no loss on liquidation of the subsidiary, although the full deficit from the subsidiary's viewpoint would remain. In such circumstances, the writing down of the parent's earnings by the amount of the subsidiary's deficit would not only defeat the Congressional intention that the tax-free transaction is to have no effect on the parent's earnings or profits, but would also cause a disappearance of

[1] Cf. Section 129 of the Internal Revenue Code, as added by Section 128 of the Revenue Act of 1943, c. 63, 58 Stat. 21, which is applicable to years beginning after December 31, 1943, and which terms disallows a deduction, credit, or other allowance to a corporation or persons in circumstances where, for the principal purpose of securing a deduction,

the parent's earnings available for dividends in circumstances where its stockholders are not entitled to that advantage even as a matter of corporate accounting.[14]

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credit, or other allowance which it or they would not otherwise enjoy, the corporation or the persons acquire on or after October 8, 1940, directly or indirectly, property or control of another corporation not previously controlled by it or them and where the corporation's basis of the property is determined by reference to the basis in the hands of the transferor corporation. S. Rep. No. 627, 78th Cong., 1st Sess., pp. 58–61 (1944 Cum. Bull. 973, 1016–1018), explains this section in detail and indicates (pp. 60–61) that it would not apply in connection with a tax-free complete liquidation under Section 112 (b) (6) because, under such circumstances, there would not be an acquisition of control within the meaning of the section.

[14] It should be noted also that the parent corporation and its subsidiaries filed consolidated returns for the years 1918 to 1933, inclusive. (R. 12.) Although the stipulation does not show in what years the operating losses of the subsidiaries (which resulted in their deficits) were incurred and to what extent they were set off against the parent corporation's net income in the consolidated return years, it is a fair inference that the annual operating losses of the subsidiaries reduced the parent corporation's annual net income in some amount in those years.

The operating losses of the subsidiaries availed of by the parent corporation on consolidated returns were required to be subtracted by the parent corporation from its cost of the subsidiaries' stock in determining its adjusted basis for computing gain or loss on disposition of the stock under Article 113 (b)-1 of Treasury Regulations 94 (Appendix, *infra*, p. 87). The reduction of the parent corporation's basis by the operating losses of the subsidiaries so availed of may very well have represented a return to the parent corporation of the cost of the subsidiaries' stock in full and thus have resulted in its having no realized loss on liquidation of the subsidiary corporations in 1936. Cf. *Taylor-Wharton*

The view that the *Sansome* rule does not apply to deficits is not to be rejected because the treatment of losses would as a result differ somewhat from the treatment of gains realized on liquidation of a subsidiary corporation or on a statutory reorganization. To be sure, a gain to a parent corporation upon the liquidation of a subsidiary would not be recognized as includible in income under Section 112 (b) (6) and would not be reflected in the earnings account for tax purposes under Article 115–3 of Treasury Regulations 94 and Section 115 (l) of the Internal Revenue Code. Nevertheless, the *Sansome* rule operates in such case to transfer the accumulated earnings or profits of the subsidiary to the parent as earnings. The employment of this principle, limited to earnings or profits, does not, however, run counter to the Congressional intent, for in enacting Section 501 of the Second Revenue Act of 1940, which added Section 115 (l) to the Code, and which provides that unrecognized gains and losses are not to increase or decrease earnings or profits, the Congressional reports expressly stated that the *Sansome* rule was to operate in conjunction therewith. H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526):

Iron & Steel Co. v. *Commissioner*, 5 T. C. 768, 781–782, which however, was concerned on those pages with a loss on liquidation of a subsidiary which was *recognized* under the law as it stood at the time and which therefore would reduce earnings or profits under Section 115 (l) of the Code.

S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 528, 546–547). The reports refer to the rule as affecting earnings and profits only, and the absence of a corresponding reference to deficits is especially significant here. Section 501 dealt not only with gains but also with losses, and in correlating the *Sansome* rule with the section, the term "losses" would presumably have suggested to the Congressional committees the possibility of a deficit in the financial structure of the liquidating or transferor corporation, just as the term "gains" suggested earnings or profits in that connection. Congress' silence in respect of deficits here implies even more strongly than its general silence in this respect (see *supra*, pp. 22–28) that it regarded the *Sansome* rule as affecting only earnings or profits.

[15] The Senate Committee explained as follows (S. Rep. No. 2114, p. 25):

"Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. These principles are to be given full effect under section 501. The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee."

Not only did Congress expressly indicate that the earnings of the liquidated subsidiary were to increase the earnings of the parent corporation, even though the gain on the liquidation was not recognized to the parent, but that result would be required in any case in order not to frustrate the direction of Section 115 (a) and (b) that corporate profits are to be taxed to the shareholders as dividends upon their distribution. *Commissioner* v. *Munter*, 331 U. S. 210. In contrast, Congress has given no indication that the deficit of a liquidated subsidiary is to reduce the accumulated earnings of the corporation which acquires its assets, nor is that reduction required to carry out the direction of Section 115 (a) and (b). As shown, to do so would defeat Section 115 (a) and (b).

Nor should the *Sansome* rule be enlarged to embrace deficits merely because there is a possibility that the parent corporation's accumulated earnings or profits may not in the future, for tax purposes, reflect fully the loss, if any, which the parent corporation sustained on the liquidations.[16] This possibility occurs as a result of the Congressional direction in Section 113 (a) (15) of the Revenue Act of 1936 (Appendix, *infra*, p. 69) that the parent corporation is to take, as its basis

[16] Earnings or profits in the tax sense do not necessarily follow corporate accounting concepts nor is there any requirement that they do so. See *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892.

for computing gain or loss on sale or other disposition of the assets acquired from the subsidiaries, the basis of those assets in the hands of the subsidiaries.[17] To the extent that each subsidiary's cost basis for its assets, which the parent must use as its basis for those assets, varied from the parent's total investment in the stock of the subsidiary, the parent's gain or loss upon disposition of the assets will not reflect precisely the unrecognized loss it may have sustained at the time of liquidation upon the exchange of its stock investment for assets of a lesser value. Under Section 115 (l) of the Internal Revenue Code, the gain or loss at the time the assets are disposed of, if recognized, will be the amount by which the parent corporation's earnings or profits are then increased or decreased.

As already noted, the record in this case does not show that the parent corporation sustained a loss on liquidation of the subsidiaries. Furthermore, it does not appear that the basis of the assets in the hands of the parent corporation is different from its basis for the stock of the

[17] The subsidiaries' basis for the assets would of course be the actual cost of the assets to them under Section 113 (a), unless the assets had been acquired in a way which caused one of the exceptions to the general rule of Section 113 (a) to apply. The basis of each subsidiary for its assets was not necessarily correlated with its deficit. The basis for the assets on hand at the time of liquidation depended on the amount paid for the assets initially whereas the deficits resulted from the loss of other assets in operations. Cf. *Putnam* v. *United States*, 149 F. 2d 721, 726 (C. C. A. 1st).

subsidiaries surrendered in exchange for the assets. Hence, even under ordinary accounting concepts there is no factual basis here for reducing the parent corporation's earnings in 1936 by the deficits on the assumption that the earnings will not thereafter be reduced properly to reflect the loss sustained in 1936. But assuming for purposes of argument that both a loss and a difference in basis were proved, it is clear that, on the date of the liquidations, it could not be known whether or not the parent corporation would have a gain or loss upon the ultimate disposition of the assets in the future or, if it would have either gain or loss, the extent thereof. It follows that a reduction of the earnings by the subsidiary's deficit on the date of liquidation, on the theory that this adjustment will take account of a loss which can be reflected in no other way, may well reduce the earnings much more (or less) than the future events would warrant. As already shown, the subsidiary's deficit does not necessarily correspond in amount to the parent's loss on liquidation.

Finally, the assumption that all of a corporation's losses must for tax purposes be deducted from its earnings or profits is not justified. It is well settled that whether and to what extent a deduction for a loss or other item is allowable is a matter of legislative grace. *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, 593; *Deputy* v. *du Pont*, 308 U. S. 488, 493;

White v. *United States*, 305 U. S. 281; *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440. It follows that Congress is not obliged to grant a deduction for any particular loss in determining taxable income, except perhaps where not to do so would result in subjecting capital to the income tax. It is reasonable to apply the same rule to the determination for tax purposes of the accumulated earnings or profits which are available for dividends. *Commissioner* v. *Wheeler*, 324 U. S. at 546. The parent corporation therefore would have no ground for complaint, even though the loss sustained by it on the liquidations is never fully deductible and is never fully reflected in its computation of earnings or profits for tax purposes.

A stockholder, rather than the corporation, is the taxpayer in this case, however. The stockholders stand in a different position from their corporation. Any actual losses sustained by their corporation upon the liquidations would be reflected in its balance sheet and would have their effect on the value of its stock. Thus, when the stockholders dispose of their stock, the price which they receive will reflect the corporation's losses; the effect of such a reflection of losses will be to reduce the stockholder's capital gain if his basis is smaller than the amount realized on disposition, or to permit the stockholder a capital loss allowance if his basis is greater than the amount realized. Thus it does not appear in this case, and

it could not be shown that taxation of the distribution from the parent corporation's earnings or profits, unreduced by the subsidiaries' deficits, to its stockholders will operate to prevent them from ever having their total capital investment in the stock of the parent corporation recognized as being free from income tax. They would have grounds for complaint only if this were true. Cf. *Commissioner* v. *Sansome, supra*, 60 F. 2d at 932; Paul, *Selected Studies in Federal Taxation* (Second Series), pp. 151–152, 166; 1 Mertens, *Law of Federal Income Taxation*, Secs. 5.06 and 9.29, pp. 171, 460–461.

D. *The reading put upon the* Sansome *rule by the court below finds no support in prior decisions.*—Although the rule of the *Sansome* case has been applied in the federal courts and has been the subject of litigation in those courts for more than sixteen years, never before has that rule been held to apply to permit an operating deficit of a predecessor corporation to wipe out the successor's accumulated earnings and profits.

The only previous decision directly concerned with the deficit of a liquidated corporation which transferred its assets to another corporation tax-free held that the deficit did not pass as a deficit to the succeeding corporation. In *Cranson* v. *United States*, 146 F. 2d 871 (C. C. A. 9th), certiorari denied, 326 U. S. 717, pursuant to tax-free complete liquidations in 1936, a parent corporation acquired the net assets of three wholly owned

subsidiary corporations, which together had an aggregate operating deficit of $1,205,451.61. Later in 1936, the parent made a distribution of $1 per share to its stockholders, totalling $937,743.[18] The parent's current earnings for the year 1936 were $931,553.82 and its accumulated earnings at the beginning of that year were $139,631.26. The taxpayer's contention was that, under the *Sansome* rule, the aggregate operating deficit of the subsidiaries, or alternatively, the losses sustained by the parent on the liquidations (which exceeded the total of the deficits by a small amount), eliminated the current earnings of the parent for 1936 and also part of its accumulated earnings at the beginning of the year, with the result that only a small part of the distribution in 1936 was a taxable dividend[19] under Section

[18] Although the court's opinion did not state the number of shares of the parent's stock which were outstanding at the time of the distribution, as the Tax Court noted (R. 22), the record in the case, which was before this Court on petition for a writ of certiorari, showed (R. 38, No. 85, 1945 Term) that the shares outstanding throughout 1936 were 937,743, on which four cash distributions of 25 cents per share each were made in 1936.

[19] The complaint alleged that $432 of the distribution of $450 to the taxpayer in 1936 was a capital distribution (R. 10–11, No. 85, 1945 Term), but the failure to claim that the remaining $18 was from capital was not because the taxpayer conceded that the parent's accumulated earnings at the beginning of the year 1936 remained undisturbed by the subsidiaries' deficits and a source for dividend payments. Rather his position was that the $139,631.26 of accumulated earnings as of January 1, 1936, should be reduced by the net loss for the year 1936 (subsidiaries' deficit of $1,205,451.61

115 (a) and (b) of the Revenue Act of 1936. The Court of Appeals for the Ninth Circuit held that the entire distribution in 1936 was a taxable dividend, deciding first that the parent's earnings of $931,553.82 for 1936 were not extinguished by either the deficits of, or the losses on liquidation of, the subsidiaries, and second that the accumulated earnings of the parent at the beginning of 1936 were likewise not erased by the deficits of, or the losses on liquidation of, the subsidiaries. The latter holding was expressed in the final paragraph of the court's opinion, where it said (p. 872):

> It being admitted that $931,553.82 earnings or profits were made in 1936 by the parent corporation and besides it had on hand undistributed profits of $139,631.26, the total amount exceeding that distributed to the stockholders, they were held properly by the tax court [sic] to be taxable as

minus parent's 1936 earnings of $931,553.82, or $273,897.79) prorated on a daily basis to March 14, 1936, the date of the payment of the first of the four 25-cent distributions, and that the remainder of the accumulated earnings (about $82,500) would be available for the payment of that dividend. (Pet. 6, fn. 2, No. 85, 1945 Term.) The contention was therefore that the deficits applied first to diminish current year's earnings and, that the excess of the deficits over current earnings became an operating loss of the parent for the year in which the liquidation occurred, which applied against and reduced the accumulated earnings to the extent that the loss could be assumed to have been incurred on the date the distribution was made. The Ninth Circuit's decision rejected this contention in its entirety.

> dividends to the distributees, of which the appellant is one. * * *

Whether or not the court's opinion is regarded as explaining its decision fully, the court unquestionably held that the entire distribution was a taxable dividend; it therefore necessarily decided that the accumulated earnings, as well as the current earnings, were not eliminated or reduced by the subsidiaries' deficits under the *Sansome* doctrine, since the current earnings for 1936 were insufficient alone (to the extent of $6,189.18) to cover the entire distribution. This holding with respect to the accumulated earnings was reaffirmed in a subsequent case involving a distribution by the parent corporation in 1938. *Cranson* v. *United States* (N. D. Cal.), decided November 12, 1943 (32 A. F. T. R. 1640), affirmed *per curiam*, 151 F. 2d 1021 (C. C. A. 9th).[20]

[20] The parent again distributed $937,743 in 1938, a year in which its current earnings or profits were only $695,694.64. The excess ($242,048.36) of the distribution over current earnings represented a taxable dividend only if the parent's accumulated earnings survived intact and unreduced after the 1936 transaction in which it had liquidated the three subsidiaries having deficits. The district court held that the deficits of the subsidiaries as of the date of their liquidation in 1936 did not diminish the parent's earnings or profits otherwise available for distribution to its stockholders during 1938, and this was affirmed *per curiam* on appeal pursuant to stipulation that the final decision in *Cranson* v. *United States*, 146 F. 2d 871 (C. C. A. 9th), certiorari denied, 326 U. S. 717, would be controlling. The district court's holding in this case necessarily applied exclusively to the parent's accumulated earnings, because it could not have been con-

Contrary to the views of both lower courts in the present case (R. 21–22, 32), the *Cranson* cases therefore did decide that the operating deficits of subsidiary corporations completely liquidated in 1936 in a tax-free transaction did not destroy the parent corporation's own accumulated earnings as of the date of the liquidation for taxable dividend purposes. The *Cranson* cases involved facts and circumstances substantially identical to those in this case and they affirmatively support our view that a deficit is not transferred under the *Sansome* doctrine. As previously stated, no other case has applied the *Sansome* rule to transfer a deficit.

Harter v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d), on which both lower courts relied (R. 17–19, 32), presented the typical *Sansome* factual situation in which corporations acquired the assets of predecessor corporations which had accumulated earnings or profits. The *Harter* opinion in fact dealt with two typical *Sansome* transactions. First, a new company acquired the assets of two old companies in a tax-free reorganization and it was held that the new company inherited the accumulated earnings of the old companies as earn-

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tended on any theory that the current earnings for 1938, which under Section 115 (a) were an independent source for payment of dividends irrespective of whether or not the corporation had accumulated earnings, were eliminated by the deficits or losses sustained on liquidations occurring two years before 1938.

ings under the *Sansome* principle. Later, in 1926, the new company was merged into the Boxboard Company, an existing corporation, which had a deficit of $17,388.95. It was again held that the Boxboard Company, which acquired the assets of the new company, also acquired its accumulated earnings as earnings. As the court pointed out (p. 13), the new company, prior to the merger, had accumulated earnings or profits acquired from the old companies of $2,085,587.78, and these carried over as earnings in the consolidation with Boxboard and remained earnings in Boxboard's hands. This left Boxboard with accumulated earnings of $2,068,198.83 ($2,085,587.78 minus Boxboard's deficit of $17,388.95), available to pay dividends to its stockholders.

Thus, the *Harter* case merely reiterates the *Sansome* rule that the accumulated earnings of a corporation are transferred as earnings to the corporation which acquires all of its assets in a statutory reorganization. It is not authority for and there is no dictum in the opinion supporting, the view that a corporation acquiring the assets of another company will be permitted to treat that other company's deficit as its own in reduction of its own accumulated earnings.

The Tax Court in this case (R. 18–19) pointed to the fact that, in the *Harter* case, Boxboard's own deficit was subtracted from the earnings

acquired from the predecessor,[21] but it failed to observe that this was not a step in determining whether the *Sansome* principle operated in that case to transfer the earnings; it was done only for the purpose of determining the *amount* of the accumulated earnings available for distribution as dividends by Boxboard, *after* it had been held that the predecessor's earnings had been received as earnings by Boxboard under the *Sansome* rule.

[21] As previously pointed out (fn. 2, p. 11, *supra*), prior to Section 115 (a) of the Revenue Act of 1936, which first established the current year's earnings as an independent source for dividends, only the earnings accumulated after February 28, 1913, were for tax purposes regarded as a source from which taxable dividends could be paid. In transactions occurring prior to 1936, it is the settled rule that where a corporation, such as Boxboard, had a deficit in its earned surplus account caused by operating losses, the deficit must have been restored in its entirety by applying against the deficit earnings received subsequently, before any of the subsequent earnings might be considered as accumulated earnings and available for distribution as a taxable dividend. Stated another way, the subsequent earnings were not available for dividend purposes, so long as an operating deficit existed. *Van Norman Co.* v. *Welch*, 141 F. 2d 99 (C. C. A. 1st); *Foley Securities Corp.* v. *Commissioner*, 106 F. 2d 731 (C. C. A. 8th); *Commissioner* v. *W. S. Farish & Co.*, 104 F. 2d 833 (C. C. A. 5th); *Sale* v. *Commissioner*, 35 B. T. A. 938, 939; 1 Mertens, *Law of Federal Income Taxation*, Section 9.30; cf. *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215. *Contra* is *Blair* v. *United States*, 63 C. Cls. 193, certiorari denied, 275 U. S. 546, which was disapproved in the *Sale* case, *supra*. And compare *Pembroke Realty & S. Corp.* v. *Commissioner*, 122 F. 2d 252 (C. C. A. 2d), with *Brooklyn National Corp.* v. *Commissioner*, 157 F. 2d 450 (C. C. A. 2d), certiorari denied, 329 U. S. 733.

In the *Harter* case the events and distributions occurred long prior to 1936, and it was therefore necessary for the court

In the present case, the issue is whether the *Sansome* doctrine applies to transfer the deficits of the subsidiaries to the parent corporation as deficits, and this question is not resolved by the *Harter* case which applied the principle only to transfer earnings. Not until it had first been determined that the *Sansome* rule does transfer the deficits would there be occasion to apply the rule of the second step involved in the *Harter* case, that of combining the acquired deficits with the already existing earnings for purposes of determining the amount of accumulated earnings available for dividend purposes. It follows that the *Harter* decision does not lend any support to the judgment of the Court of Appeals in this case, as Judge Huxman, dissenting, pointed out (R. 35–36).

Nor did *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124, petition for review dismissed February 5, 1947 (C. C. A. 6th), to which the Tax Court referred (R. 19–20), decide the question as to whether the *Sansome* rule is to be extended to deficits. One question there was whether the taxpayer corporation had a deficit in accumulated earnings or profits at the beginning of the tax year, with the result that it was entitled to a

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to apply the earnings received by Boxboard as the acquiring corporation under the *Sansome* rule, first to restore Boxboard's own deficit, and to determine that only the excess of the acquired earnings over Boxboard's deficit represented the accumulated earnings in its hands available for dividend purposes.

deficit credit against income for purposes of computing its surtax on undistributed profits under Section 26 (c) (3) of the Revenue Act of 1936, as added by Section 501 (a) (2) of the Revenue Act of 1942, c. 619, 56 Stat. 798. Prior to the tax year it had transferred a part only of its assets to another company in a reorganization at a time when, as it contended, it had a deficit. Both parties agreed that, if it had a deficit at such time, the deficit was divisible between the two corporations, and the only issue was as to the method of division. Hence, the Tax Court was not required to decide whether a transferee corporation inherits the transferor's deficit in a reorganization. The case was concerned only with the amount of the deficit retained by the transferor after it had disposed of some of its assets.

The Tax Court also cited *Mandel* v. *Commissioner*, 5 T. C. 684 (R. 20–21), but that case is not apposite; it was concerned with the apportionment of the accumulated earnings of the old company as between it and a new company which acquired some of its assets; the earnings apportioned to the new company were of course held to be carried over intact to it under the *Sansome* rule.

And, finally, although in *Crocker* v. *Commissioner*, 29 B. T. A. 773, it was assumed without proof that one of three predecessor corporations, the assets of which were transferred to a successor

corporation in a tax-free reorganization, may have had a deficit, nevertheless, since the combined surplus of the three predecessors together was stipulated to be in excess of the distribution in question made by the successor corporation, it was held that the distribution was a taxable dividend. The case did not undertake to decide whether or not the assumed deficit of the one predecessor would have reduced the accumulated earnings of the successor corporation or the earnings of the other predecessors acquired as such under the *Sansome* principle by the successor.

E. *The decision of the court below is squarely in conflict with the Congressional assumption as to the scope of the* Sansome *rule as evidenced in the statutory provisions dealing with the computation of equity invested capital for excess profits tax purposes.*—Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, added a new subchapter to the Internal Revenue Code imposing a graduated surtax on excess profits, *i. e.*, profits in excess of normal profits, of corporations commencing with the year 1940.[22] One measure of the normal profits was a figure equal to a stated percentage of the "invested capital", which was allowed as a credit in arriving at the income subject to excess profits tax. Sections 710, 711, 712,

[22] Section 122 (a) of the Revenue Act of 1945, c. 453, 59 Stat. 556, provided that the provisions of the excess profits subchapter should not apply to taxable years beginning after December 31, 1945.

and 714 of the Code (26 U. S. C. 1946 ed., Secs. 710, 711, 712, and 714). Invested capital, for purposes of computing the allowable credit, was composed of "borrowed invested capital" and "equity invested capital". Section 717 (26 U. S. C. 1946 ed., Sec. 717.) See *Commissioner* v. *South Texas Co.*, 333 U. S. 496.

Section 718 (a) of the Code (Appendix, *infra*, pp. 74–76), as originally enacted in 1940, defined "equity invested capital" as the sum of (1) the money previously paid in for stock, or as paid-in surplus, or as a contribution to capital; (2) property previously paid in for stock, or as paid-in surplus, or as a contribution to capital, such property to be included in an amount equal to its unadjusted basis for determining loss upon sale or exchange; (3) previous distributions of stock which were considered distributions of earnings or profits; (4) the accumulated earnings or profits at the beginning of the year; and (5) the amount by which the aggregate of the money and the adjusted basis of property received in a non-taxable complete liquidation of a subsidiary corporation exceeded the aggregate of the parent's adjusted basis of the stock in the subsidiary and the liabilities it assumed. The sum of these amounts was to be reduced by the sum of the amounts described in Section 718 (b), Appendix, *infra*, pp. 76–78. These consisted of (1) and (2) previous distributions not out of earnings and profits; (3) the earnings and profits of another corporation which

had previously been included in the taxpayer's accumulated earnings and profits under the *Sansome* rule or by reason of a transfer by the other corporation to the taxpayer corporation of property, the basis of which, in the hands of the taxpayer, is determined by its basis in the former corporation's hands; and (4) the amount by which the aggregate of the taxpayer's adjusted basis for stock in a subsidiary corporation, previously liquidated by it in a tax-free liquidation, and the liabilities of the subsidiary which were assumed in the liquidation, exceeded the aggregate of the money and the adjusted basis of the subsidiary's property received in the liquidation (the amount of this reduction was not to exceed the accumulated earnings and profits at the beginning of the taxable year).

These provisions, as well as the later amendments, were, as we shall show, drafted on the assumption that the accumulated earnings and profits as of the beginning of the taxable year, which are to be included in invested capital under Section 718 (a) (4), would not, under the *Sansome* rule, have been reduced by the deficit of another corporation previously liquidated in a tax-free transaction. If, contrary to the legislative understanding, the *Sansome* rule is held to apply to a deficit, a distortion of the amount of equity invested capital under Section 718 will, in every case in which the assets of a deficit corporation have previously been acquired in a tax-free trans-

action, result. This distortion would seriously affect the structure of the excess profits tax, since "equity invested capital" is often a basic element in the computation of that tax. The Congressional understanding in this field of taxation thus has a twofold importance: it bears directly on the correctness of the decision below, and, collaterally, gives cause for serious concern lest a basic factor in the excess profits tax system be distorted by an inconsistent judicial interpretation.

1. In Section 718 (b) (3), Congress expressly provided for a reduction of equity invested capital by the earnings and profits of another corporation which previously had been included in the taxpayer's accumulated earnings or profits by reason of a non-taxable transaction described in Section 112 (b) to (e), inclusive, or by reason of a transfer by the other corporation to the taxpayer corporation of property, the basis of which in the hands of the taxpayer is determined by reference to its basis in the former corporation's hands. The purpose of this section, as explained in the committee reports, was to avoid a duplication in the computation of the taxpayer's invested capital by reason of the double inclusion therein of the earnings or profits of the previous corporation. H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 496, 514); S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 6, 14 (1940-2 Cum. Bull. 528, 532, 539); H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940-2 Cum.

Bull. 548, 555). The duplication referred to in the reports is, in the case of a tax-free reorganization, that resulting from the inclusion in invested capital of the former corporation's earnings or profits under the provisions of both Section 718 (a) (2) and Section 718 (a) (4). Thus, where the taxpayer corporation in exchange for its stock had previously acquired the assets of another corporation in a tax-free reorganization, any earnings or profits represented by those assets would have been transferred under the *Sansome* rule to the taxpayer corporation, would be reflected in the amount of its accumulated earnings and profits at the beginning of the taxable year, and would, therefore, be includible in its invested capital under Section 718 (a) (4). Furthermore, in these circumstances, the basis for the assets in the previous corporation's hands would have carried over to become the corporation's basis for the assets and, under Section 718 (a) (2), the transferred earnings of the previous corporation would again be reflected in the taxpayer's invested capital as a part of the assets paid in for stock, the old basis for the assets being treated as the amount paid in under that section.[23] The effect of Section

[23] The Congressional understanding seems to have been that accumulated earnings and profits or a deficit in the earnings account would be reflected in the transferor's adjusted basis. H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 496, 514). And see S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 193-194 (1942-2 Cum. Bull. 504, 646) quoted *infra*, fn. 29, pp. 63-64).

718 (b) (3) is to reduce invested capital in the amount by which, under the *Sansome* rule, the earnings or profits of the predecessor corporation would be reflected in the taxpayer corporation's accumulated earnings for purposes of Section 718 (a) (4). Cf. *Crossett Western Co.* v. *Commissioner*, 155 F. 2d 433 (C. C. A. 3d), certiorari denied, 329 U. S. 729.[24]

If the former reorganized corporation had had a deficit, instead of earnings or profits, and if the *Sansome* rule had operated to transfer the deficit to the taxpayer corporation, Congress would have been faced with the same problem of duplication in equity invested capital, as in the case of earnings. The former corporation's basis for the assets acquired would reflect its deficit and since this basis would be the amount at which the assets would be includible in invested capital under Section 718 (a) (2), the deficit would be reflected in the amount includible under that section as property paid in for stock. If the deficit had been inherited by the taxpayer corporation under the *Sansome* rule,

[24] In the *Crossett Western* case, it was held that the invested capital must be reduced under Section 718 (b) (3) by the amount of the earnings and profits of predecessor corporations which, under the *Sansome* rule, had in a previous year been included in the taxpayer corporation's earnings or profits, even though the subsequent operations of the taxpayer corporation had resulted in losses which wiped out the earnings acquired from the predecessor corporations so that at the beginning of the taxable year, the taxpayer corporation had a deficit in its earned surplus account.

the deficit would have reduced the taxpayer corporation's accumulated earnings; the deficit, consequently, would also be reflected in the amount of the earnings includible in invested capital under Section 718 (a) (4). To eliminate this double reflection of the deficit in invested capital, a special provision would have been necessary, by analogy to Section 718 (b) (3), increasing equity invested capital by the amount of the deficit previously deducted from the taxpayer's accumulated earnings. Congress did not, however, in 1940 (but see the discussion of Section 718 (a) (7) added in 1942 in point 3, *infra*, pp. 62–66) provide for an increase of invested capital to correspond to the amount of the reorganized corporation's deficit, which it would be expected to have done if it had understood or assumed that the *Sansome* rule applied to transfer deficits. The failure to include a provision designed to eliminate the double inclusion of the former corporation's deficit in invested capital under Section 718 (a) (2) and (4), which would result if the *Sansome* rule had transferred the deficits, is a clear indication that Congress did not regard the *Sansome* rule as applying to transfer to the taxpayer corporation the deficit of a former corporation.

Congress' assumption that the *Sansome* doctrine did not apply to deficits is all the more evident from the fact that, in drafting the legislation, Congress was expressly concerned with

deficit corporations as well as with those which had earnings. Congress recognized that the taxpayer corporation might have a deficit, rather than accumulated earnings at the beginning of the tax year, but it did not allow invested capital to be reduced by the deficit under Section 718 (a) (4); on the contrary, that section directs that only the accumulated earnings or profits as of the beginning of the taxable year (as distinguished from a deficit) shall be included in invested capital.[25] Since the possibility that the taxpayer corporation would have a deficit was recognized, it seems reasonable to infer that the same possibility in the case of a predecessor corporation also occurred to the legislators. In these circumstances, the failure to include a provision, similar to Section 718 (b) (3), for increase of invested capital by the amount of the deficit of a predecessor corporation previously deducted from accumulated earnings of the taxpayer derives added significance.

Furthermore, it seems plain that if the tax-

[25] H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 496, 514), stated, in connection with Section 718 (a) (4), that a deficit in accumulated earnings or profits at the beginning of the year shall not be taken into account but the earnings at that time shall be *zero* for purposes of computing the equity invested capital. Section 30.718–2 of Treasury Regulations 109, relating to the Excess Profits Tax under the Internal Revenue Code, incorporated this language and provided also that subsequent earnings and profits shall be applied to restore the deficit. This is in line with the general rule for income tax purposes. Fn. 21, pp. 46–47, *supra*.

payer corporation's own deficit at the beginning of the tax year could not reduce its invested capital as H. Rep. No. 2894, fn. 25, p. 56, *supra*, indicates, Congress would hardly have conceived that a deficit of a corporation previously liquidated could do so by means of the reduction of the taxpayer's accumulated earnings under the *Sansome* rule in a prior year.

2. The provisions of Section 718 (a) (5) and (b) (4) establish that Congress understood that the deficits of corporations previously completely liquidated tax-free under Section 112 (b) (6) were not transferred as such under the *Sansome* principle.

In the case where the taxpayer corporation had liquidated a subsidiary, the money and property originally paid in for the taxpayer's stock, to be included under Section 718 (a) (1) and (2), would not be affected by the transaction, as they would be in the case of a reorganization where stock is issued directly for property. Nevertheless, under Section 113 (a) (15) of the Internal Revenue Code, for income tax purposes, the taxpayer would be required to take as its basis for the assets acquired in the liquidation the basis of the assets in the subsidiary's hands. Congress was of course aware in 1940 that the former corporation's basis for such assets would not necessarily correspond to the taxpayer corporation's former investment in the stock of the liquidated corporation; and that, to the ex-

tent of the difference between its investment in the liquidated corporation and the former corporation's basis of the assets received in exchange for its investment on the liquidation, the taxpayer corporation would have realized a gain or loss on the liquidation of the other corporation which, however, was not recognized for income tax purposes at that time and would not be reflected in its accumulated earnings or profits at the beginning of the tax year. Since the accumulated earnings to be included in invested capital under Section 718 (a) (4) would not reflect the gain or loss on the previous liquidation, Congress recognized that an adjustment was necessary. Accordingly, it provided in Section 718 (a) (5) and (b) (4) for an adjustment of invested capital in the case of a tax-free complete liquidation of a former subsidiary, which would substitute the subsidiary's adjusted basis for the assets in place of the corporation's adjusted basis for the subsidiary's stock surrendered in exchange for the assets.[26] The effect of this adjustment is

[26] Section 718 (a) (5) and (b) (4) were inserted in conference. H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940–2 Cum. Bull. 548, 555), stated with respect to them:

"The conference agreement also makes further technical changes in order to eliminate duplications in the computation of equity invested capital. Provisions have been inserted governing the extent to which the equity invested capital of a parent corporation is to be increased or decreased following a liquidation under section 112 (b) (6). This provision enables the provisions of section 718 (b) (3) to be

to recognize for invested capital purposes, although it is not recognized for income tax purposes under Section 113 (1), that part of the gain or loss to the taxpayer-parent corporation represented by the receipt of assets on liquidation at a basis greater or less than its basis for the stock in the subsidiary. Cf. *Taylor-Wharton Iron & Steel Co.* v. *Commissioner*, 5 T. C. 768, 784–785, in which the Tax Court stated (p. 785) that Section 718 (b) (4) requires a reduction of invested capital by the amount of a loss on liquidation of a subsidiary which is not recognized for income tax purposes.

If the deficit of a former subsidiary had carried over under the *Sansome* principle to reduce the corporation's accumulated earnings, the amount of the accumulated earnings at the beginning of the tax year, includible under Section 718 (a) (4) in invested capital, would reflect (although not always accurately, see *supra*, pp. 29–30, 32–33) the loss on the liquidation, and Section 718 (b) (4) would direct an adjustment for the same loss, thus duplicating the effect of the *Sansome* rule.[27] The

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expanded so as to cover all situations in which, under the doctrine of *Commissioner* v. *Sansome* (60 Fed. (2d), 931), the earnings and profits of one corporation become the earnings and profits of another. * * *"

[27] Our point may be clarified by an example: The invested capital of the A corporation is to be computed. The property paid in for its stock originally was $150,000. At the beginning of the year it has accumulated earnings of $50,000. Previously A had invested $100,000 in stock of B corporation, which it wholly owned. B had incurred an operating

inclusion of Section 718 (b) (4), the purpose of which was to eliminate duplications (fn. 26, pp. 58–59, *supra*), is clear evidence that Congress understood and assumed that the deficit of a liquidated subsidiary corporation would not reduce the parent's earnings under the *Sansome* rule, and that the *Sansome* doctrine was confined in its operation to earnings or profits (cf. fn. 26, pp. 58–59, *supra*).

This is confirmed by comparing the situation existing if the liquidated subsidiary had had accumulated earnings. Those earnings would of course have previously increased the parent's accumulated earnings under the *Sansome* rule and would be reflected in the accumulated earnings includible in invested capital under Section 718 (a) (4). And as in the deficit situation, the basis adjustment required by Section 718 (a) (5) to reflect the taxpayer corporation's gain on the liquidation would duplicate the *Sansome* increase

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deficit of $25,000 and its original assets of $100,000 had thereby shrunk to $75,000. Upon complete liquidation prior to the taxable year, A took over the B assets at a basis of $75,000. Thus, A's invested capital is $150,000 (Section 718 (a) (2)), plus $50,000, the accumulated earnings (Section 718 (a) (4)), reduced by the loss of $25,000 on the liquidation (Section 718 (b) (4)), or $175,000. If the B deficit of $25,000 had carried over to reduce A's accumulated earnings of $50,000 at the time of the liquidation, A's invested capital would be $150,000 (Section 718 (a) (2)), plus $25,000, the reduced accumulated earnings (Section 718 (a) (4)), minus $25,000, the loss on the liquidation (Section 718 (b) (4)), resulting in a final invested capital of only $150,000.

to the accumulated earnings, were it not for the fact that under Section 718 (b) (3), Congress expressly directed the subtraction of the subsidiary's earnings formerly included in the parent's earnings under the *Sansome* rule. In the deficit situation there is no section, corresponding to Section 718 (b) (3), which is designed to remove the duplication which would result if, under the *Sansome* rule, the deficit had been transferred into the parent's accumulated earnings account. The absence of a section, corresponding to Section 718 (b) (3), having for its purpose the prevention of a duplication in invested capital which would result from the reflection of the deficit of a liquidated corporation in the accumulated earnings at the beginning of the year includible under Section 718 (a) (4) (if the *Sansome* rule had transferred the deficit) and from the reflection of the loss on the liquidation taken into account by Section 718 (b) (4), is an additional indication that, within Congress' understanding and intention, the *Sansome* rule would not have transferred the deficit.[28]

[28] Section 230 (c) of the Revenue Act of 1942, c. 619, 56 Stat. 798, provided that Section 718 (a) (5) and (b) (4) should not apply to any taxable year beginning after December 31, 1941, but in place of these subsections, Section 230 (a) of the 1942 Act added Section 761 to the Internal Revenue Code. Section 761 (Appendix, *infra*, pp. 79-86) deals with transfers of property pursuant to tax-free intercorporate liquidations and provides for adjustments to invested capital, somewhat different from, and more complicated than, those made by Section 718 (a) (5) and (b) (4). The

3. By Section 219 of the Revenue Act of 1942, Congress added Section 718 (a) (7), (b) (5), and (c) (5) to the Internal Revenue Code (Appendix, *infra*, pp. 76, 78; 78–79) for application to taxable years beginning after December 31, 1939. These sections pertain to certain transfers of property by one corporation to another in exchange for the other's stock (and thus do not include a tax-free liquidation of subsidiaries of the kind involved in this case), and provide rules

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substance of Section 761 is that it adjusts invested capital of a taxpayer, by means of a plus or minus quantity (Section 761 (b) and (d)), in the amount of the difference between the taxpayer's adjusted basis for the stock in a subsidiary which has been liquidated, determined as directed, and the unadjusted basis of the assets in the hands of the subsidiary. The adjusted basis for those assets of a subsidiary attributable to such of the parent's stock as has a cost basis is determined (Section 761 (c) (1)) by substituting, as of the time the parent taxpayer acquired control of the subsidiary's stock or thereafter in certain circumstances, for the actual basis of the assets, the taxpayer's basis for the stock, and adjusting such basis thereafter to reflect the subsidiary's subsequent operations. For an explanation of Section 761 which was revised by the Senate Finance Committee, see S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 222–228 (1942–2 Cum. Bull. 504, 667–671). Without discussing these complicated provisions in detail, suffice it to say that the adjustments there provided for, like the simpler and comparable adjustments directed by Section 718 (a) (5) and (b) (4), are believed, for the reasons given in connection with Section 718 (a) (5) and (b) (4), to have been drafted upon the basic assumption that the deficits of a liquidated subsidiary would not have been transferred under the *Sansome* rule to the parent corporation and would not be reflected in the parent's accumulated earnings, to be included in invested capital under Section 718 (a) (4).

for treatment of the transferor's deficit for invested capital purposes.

Section 718 (a) (7) requires the increase of the invested capital of the transferee (the corporation acquiring the former corporation's assets) by the portion of the transferor's deficit which is attributable to its property previously received by the transferee. This provision, standing alone, cannot be construed as assuming that under the *Sansome* rule the deficit had previously reduced the accumulated earnings of the transferee which would be included under Section 718 (a) (4), in view of the legislative explanation of the section.[29]

[29] S. Rep. No. 1631, 77th Cong., 2d sess., pp. 193–194 (1942–2 Cum. Bull. 504, 646), explained the provisions as follows:

"SECTION 218. DEFICIT IN EARNINGS AND PROFITS OF ANOTHER CORPORATION.

"This section is new, no corresponding section having appeared in the House bill. Under existing law an operating loss of a corporation can reduce its invested capital through accumulated earnings and profits but cannot reduce invested capital, if there are no earnings and profits, by being deducted from the money or property paid in to such corporation. Thus, although earnings and profits increase invested capital, deficits in earnings and profits do not decrease invested capital. Under section 751 of existing law, and under section 760 which has been inserted by this bill to amend section 751, for years beginning after December 31, 1941 (relating to invested capital in case of certain tax-free exchanges), invested capital of a "transferee," as defined in such sections, is computed by taking into account the adjusted basis for determining loss in the hands of the transferee of property received from the transferor. Any loss sustained by the transferor will be reflected in the invested capital of the transferee either in a reduced basis of assets received from the transferor or in a reduced amount of prop-

As the Senate Report points out (fn. 29, *supra*), any loss sustained by the transferor (*i. e.*, its deficit) would be reflected in the invested capital

erty which will be deemed to have been paid in for stock in case the transferor used borrowed funds to pay its losses, since such sections provide for a reduction in the amount of property deemed to be paid in for stock by the amount of indebtedness of the transferor. Thus, the so-called deficit rule is not applicable in the case of such tax-free exchanges and reorganizations.

"Your committee has amended section 718 to provide that in certain cases the invested capital of a transferee, which otherwise would reflect a deficit of the transferor, will be increased by the amount of such deficit and that the invested capital of the transferor will be correspondingly reduced. The rule increasing the invested capital of a corporation by the deficit of its transferor will apply only if * * *. If these factors are present, the invested capital of the transferee otherwise computed shall be increased, and the invested capital of the transferor shall be decreased by the deficit in earnings and profits of the transferor which is attributable to the property so transferred. It is necessary to insure, however, that the transferee shall be deemed to have a deficit in earnings and profits so that subsequent earnings shall first be reduced by the amount of such deficit before any earnings and profits can be determined to have been accumulated and to increase invested capital, and to insure that the deficit of the transferor (which has been transferred to the transferee) shall not continue at the old amount, but should be reduced by the amount so transferred. Your committee has therefore provided that in computing the equity invested capital for any day after the date of acquisition of the property, the earnings and profits or deficit in earnings and profits of the transferee and the transferor shall be computed as if, immediately before beginning of the taxable year in which such transfer occurs, the transferee had been in existence and sustained a recognized loss, and the transferor had realized a recognized gain, equal to that portion of the deficit in earnings and profits of the transferor which is attributable to the property so transferred."

of the transferee (under Section 718 (a) (2)) either in a reduced basis of assets received from the transferor or in a reduced amount of property paid in for stock and thus "the so-called deficit rule is not applicable in the case of such tax-free exchanges and reorganizations." This we understand to be a statement that the *Sansome* rule would not apply to transfer the transferor's deficit as a deficit. Even though the deficit would not be reflected in the transferee's accumulated earnings as a result of the *Sansome* rule, Section 718 (a) (7) was enacted, as the report states, to increase the invested capital of the transferee by the deficit in order to counteract the reduction of invested capital resulting from the reflection of the deficit in the amount of property paid in for stock under Section 718 (a) (2).

Furthermore, Section 718 (a) (7) was accompanied by Section 718 (c) (5), under which the increase to invested capital in the amount of the transferor's deficit made by Section 718 (a) (7) is compensated for by a corresponding decrease, either then or in the future, of the transferee's earnings which are includible in invested capital.

Section 718 (c) (5) provides that the earnings or profits of the transferee (which will be included in invested capital under Section 718 (a) (4)) are to be computed as if, immediately before the taxable year in which the assets were transferred, the transferee had sustained a recognized loss equal to the portion of the deficit attributable

to the property it received. In other words, under the express provisions of Section 718 (c) (5), the deficit of the transferor is treated as carrying over to the transferee corporation as a deficit and reducing its earnings, if any, as of such time, or if the transferee then had no earnings the deficit would be retained by it as a deficit and would have to be restored from future earnings, in determining whether or not the transferee had accumulated earnings or profits to be included in invested capital under Section 718 (a) (4) for that and subsequent years. To this limited extent, Section 718 (c) (5), by express enactment, extends the *Sansome* rule to transfer the deficits of certain former corporations to their successors intact. As Senate Report No. 1631 (fn. 29, p. 64, *supra*) shows, the purpose of Section 718 (c) (5) was to insure that the transferee's earned surplus account, for invested capital purposes, had been adjusted by the transferor's deficit. But if the *Sansome* rule were also operative to transfer the deficit, then Section 718 (c) (5) would duplicate the *Sansome* transfer, with the consequence that the transferee's accumulated earnings account would reflect two times the actual deficit of the transferor. This is a further recognition that the *Sansome* rule would not operate without legislative aid in the case of a deficit, and an equally plain indication that it was not to do so except in the circumstances painstakingly delimited in Section 718 (c) (5).

CONCLUSION

The judgment of the Court of Appeals is erroneous for the reasons given and should be reversed.

Respectfully submitted.

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NOVEMBER 1948.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of gain or loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to

which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * * *

(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. * * *

* * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * * * * *

(15) *Property received by a corporation on complete liquidation of another.*—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor.

* * * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except

in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. . . .

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in *another* corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * * *

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * *

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * * *

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such gain

ized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

* * * * *

(b) *Effective date of amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under prior acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on Sep-

tember 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

Internal Revenue Code:

SEC. 718 [added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [as amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798] *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section

115 (l) for determining earnings and profits;

(3) *Distributions in stock.*—Distributions in stock—

(A) Made prior to such taxable year to the extent to which they are considered distributions of earnings and profits; and

(B) Previously made during such taxable year to the extent to which they are considered distributions of earnings and profits other than earnings and profits of such taxable years;

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year;

(5) *Increase on account of gain on tax-free liquidation.*—In the case of the previous receipt of property (other than property described in the last sentence of section 113 (a) (15)) by the taxpayer in complete liquidation of another corporation under section 112 (b) (6), or the corresponding provision of a prior revenue law, an amount, with respect to each such liquidation, equal to the amount by which the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received, exceeds the sum of:

(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in connection with the receipt of such

property, of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the taxpayer for such property so received;

* * * * *

(7) [added by Sec. 219 (a), Revenue Act of 1942, *supra*] *Deficit in earnings and profits of another corporation.*—In the case of a transferee, as defined in subsection (c) (5), an amount, determined under such paragraph, equal to the portion of the deficit in earnings and profits of a transferor attributable to property received previously to such day.

(b) *Reduction in Equity Invested Capital.*—The amount by which the equity invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in previous years.*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

(2) *Distributions during the year.*—Distributions previously made during such taxable year which are not out of the earnings and profits of such taxable year;

(3) *Earnings and profits of another corporation.*—The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits by reason of a transaction described in section 112 (b) to (e), both inclusive, or in the corresponding provision of a prior revenue law, or by reason of the transfer by such other corporation to the taxpayer of property the basis of which in

the hands of the taxpayer is or was determined with reference to its basis in the hands of such other corporation, or would have been so determined if the property had been other than money; and

(4) *Reduction on account of loss on tax-free liquidation.*—In the case of the previous receipt of property (other than property described in the last sentence of section 113 (a) (15)) by the taxpayer in complete liquidation of another corporation under section 112 (b) (6), or the corresponding provision of a prior revenue law, an amount, with respect to each such liquidation, equal to the amount by which the sum of—

(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in connection with the receipt of such property, of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the taxpayer for such property so received,

exceeds the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received. The amount of the reduction under this paragraph shall not exceed the accumulated earnings and profits as of the beginning of such taxable year;

(5) [added by Sec. 219 (b), Revenue Act of 1942, *supra*] *Deficit in earnings and profit transferred to another corporation.*—In the case of a transferor, as defined in subsection (c) (5), an amount, determined under such paragraph, equal to the portion of the deficit in earnings and profits of the transferor attributable to property transferred previously to such day.

(c) *Rules for application of subsections (a) and (b).*—For the purposes of subsections (a) and (b)—

* * * * *

(3) [as amended by Sec. 202 (f), Revenue Act of 1941, c. 412, 55 Stat. 687] *Computation of earnings and profits of taxable year.*—For the purposes of subsections (a) (3) (B) and (b) (2) in determining whether a distribution is out of the earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the tax under this subchapter or chapter 1 for such year and the determination shall be made without regard to the amount of earnings and profits at the time the distribution was made.

* * * * *

(5) [added by Sec. 219 (c), Revenue Act of 1942, *supra*] *Deficit in earnings and profits—Earnings and profits of transferor and transferee.*—If a corporation (hereinafter called "transferor") transfers substantially all its property to another corporation formed to acquire such property (hereinafter called "transferee"), if—

(A) the sole consideration for the transfer of such property is the transfer to the

transferor or its shareholders of all the stock of all classes (except qualifying shares) of the transferee. (In determining whether the transfer is solely for stock, the assumption by the transferee of a liability of the transferor or the fact that the property acquired is subject to a liability shall be disregarded);

(B) the basis of the property, in the hands of the transferee, for the purposes of this subsection, is determined by reference to the basis of the property in the hands of the transferor;

(C) the transferor is forthwith completely liquidated in pursuance of the plan under which the acquisition of the property is made; and

(D) immediately after the liquidation the shareholders of the transferor own all such stock;

for the purposes of this subchapter, in computing the equity invested capital for any day after the date of the acquisition of the property, the earnings and profits or deficit in earnings and profits of the transferee and the transferor shall be computed as if, immediately before the beginning of the taxable year in which such transfer occurs, the transferee had been in existence and sustained a recognized loss, and the transferor had realized a recognized gain, equal to the portion of the deficit in earnings and profits of the transferor attributable to such property.

(26 U. S. C. 1946 ed., Sec. 718.)

SEC. 761 [added by Sec. 230 (a), Revenue Act of 1942, *supra*]. INVESTED CAPITAL ADJUSTMENT AT THE TIME OF TAX-FREE INTERCORPORATE LIQUIDATIONS.

(a) *Definition of intercorporate liquidation.*—As used in this section, the term "intercorporate liquidation" means the receipt (whether or not after December 31, 1941) by a corporation (hereinafter called the "transferee") of property in complete liquidation of another corporation (hereinafter called the "transferor") to which

(1) the provisions of section 112 (b) (6), or the corresponding provision of a prior revenue law, is applicable or

(2) a provision of law is applicable prescribing the non-recognition of gain or loss in whole or in part upon such receipt (including a provision of the regulations applicable to a consolidated income or excess profits tax return but not including section 112 (b) (7), (9), or (10) or a corresponding provision of a prior revenue law),

but only if none of such property so received is a stock or a security in a corporation the stock or securities of which are specified in the law applicable to the receipt of such property as stock or securities permitted to be received (or which would be permitted to be received if they were the sole consideration) without the recognition of gain.

(b) *Definition of plus adjustment and minus adjustment.*—For the purposes of this section—

(1) *Plus adjustment.*—The term "plus adjustment" means the amount, with respect to an intercorporate liquidation, determined to be equal to the amount by which the aggregate of the amount of money received by the transferee in such intercorporate liquidation, and of the adjusted basis at the time of such receipt of all

property (other than money) so received, exceeds the sum of—

(A) the aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determind immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) the aggregate of the liabilities of the transferor assumed by the transferee in connection with the receipt of such property, of the liabilities (not assumed by the transferee) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the transferee for such property so received.

(2) *Minus adjustment.*—The term "minus adjustment" means the amount, with respect to an intercorporate liquidation, determined to be equal to the amount by which the sum of—

(A) the aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) the aggregate of the liabilities of the transferor assumed by the transferee in connection with the receipt of such property, of the liabilities (not assumed by the transferee) to which such property so received was subject; and of any other consideration (other than the stock with respect to which such property was received)

given by the transferee for such property so received

exceeds the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received.

(3) *Rules for application of paragraphs (1) and (2).*—In determining the plus adjustment or minus adjustment with respect to any share, the computation shall be made in the same manner as is prescribed in paragraphs (1) and (2) of this subsection, except that there shall be brought into account only that part of each item which is determined to be attributable to such share.

(c) *Rules for the application of this section.*—

(1) *Stock having cost basis.*—The property received by a transferee in an intercorporate liquidation attributable to a share of stock having in the hands of the transferee a basis determined to be a cost basis, shall be considered to have, for the purposes of subsection (b), an adjusted basis at the time so received determined as follows:

(A) The aggregate of the property (other than money) held by the transferor at the time of the acquisition by the transferee of control of the transferor (or, if such share was acquired after the acquisition of such control, at the time of the acquisition of such share, or, if such control was not acquired, at the time immediately prior to the receipt of any property in the intercorporate liquidation in respect of such share) shall be deemed to have an aggregate basis equal to the amount obtained by (i) multiplying the amount of the adjusted basis at such time of such

share in the hands of the transferee by the aggregate number of share units in the transferor at such time (the interest represented by such share being taken as the share unit), and (ii) adjusting for the amount of money on hand and the liabilities of the transferor at such time.

(B) The basis which property of the transferor is deemed to have under subparagraph (A) at the time therein specified shall be used in determining the basis of property subsequently acquired by the transferor the basis of which is determined with reference to the basis of property specified in subparagraph (A).

(C) The basis which property of the transferor is deemed to have under subparagraphs (A) and (B) at the time therein specified shall be used in determining all subsequent adjustments to the basis of such property.

(D) The property so received by the transferee shall be deemed to have, at the time of its receipt, the same basis it is deemed to have under the foregoing provisions of this paragraph in the hands of the transferor, or in the case of property not specified in subparagraph (A) or (B), the same basis it would have had in the hands of the transferor.

(E) Only such part of the aggregate property received by the transferee in the intercorporate liquidation as is attributable to such share shall be considered as having the adjusted basis which property is deemed to have under subparagraphs (A), (B), (C), and (D) of this paragraph.

(2) *Basis of stock not a cost basis.*—The property received by a transferee in an intercorporate liquidation attributable to a share of stock having in the hands of the

transferee a basis determined to be a basis other than a cost basis shall, for the purposes of subsection (b), be considered to have, at the time of its receipt, the basis it would have had had the first sentence of section 113 (a) (15) been applicable.

(3) *Definition of control.*—As used in this subsection, the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the ownership of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), but only if in both cases such ownership continues until the completion of the intercorporate liquidation.

(d) *Adjustment of equity invested capital.*—If property is received by the transferee in an intercorporate liquidation, in computing the equity invested capital of the transferee for any day following the completion of such intercorporate liquidation—

(1) with respect to any share of stock in the transferor having in the hands of the transferee, immediately prior to the receipt of any property in such intercorporate liquidation, a basis determined to be a cost basis, the earnings and profits or deficit in earnings and profits of the transferee shall be computed as if on the day following the completion of such intercorporate liquidation the transferee had realized a recognized gain equal to the amount of the plus adjustment in respect of such share, or had sustained a recognized loss equal to the amount of the minus adjustment in respect of such share;

(2) with respect to any share of stock in the transferor having in the hands of the transferee, immediately prior to the receipt of any property in such intercorporate liquidation, a basis determined to be a basis other than a cost basis, there shall be treated as an amount includible in the sum specified in section 718 (a) the amount of the plus adjustment with respect to such share, or as an amount includible in the sum specified in section 718 (b) the amount of the minus adjustment with respect to such share.

(e) *Invested capital basis.*—The adjusted basis which property received by the transferee in an intercorporate liquidation is considered to have under the provisions of subsection (c) at the time of its receipt shall be thereafter treated as the adjusted basis, in lieu of the adjusted basis otherwise prescribed, in computing any amount, determined by reference to the basis of such property in the hands of the transferee, entering into the computation of the invested capital of the transferee, or of any other corporation the computation of the invested capital of which is determined by reference to the basis of such property in the hands of the transferee.

(f) *Statutory mergers and consolidations.*—If a corporation owns stock in another corporation and such corporations are merged or consolidated in a statutory merger or consolidation, then for the purposes of this section and section 718 such stock shall be considered to have been acquired (in such statutory merger or consolidation) by the corporation resulting from the statutory merger or consolidation, and the properties of such other corporation attributable to such stock to have been re-

ceived by such resulting corporation as a transferee from such other corporation as a transferor in an intercorporate liquidation.

(g) *Determinations.*—

(1) *Regulations.*—Any determination which is required to be made under this section (including determinations in applying this section in cases where there is a series of transferees of the property and cases where the stock of the transferor is acquired by the transferee from another corporation, and the determinations of the basis and adjusted basis which property or items thereof have or are considered to have) shall be made in accordance with regulations which shall be prescribed by the Commissioner with the approval of the Secretary. If the transferor or the transferee is a foreign corporation, the provisions of this section shall apply to such extent and under such conditions and limitations as may be provided in such regulations.

(2) *Application to liquidation extending over long period.*—The Commissioner is authorized to prescribe rules similar to those provided in this section with respect to the days within the period beginning with the date on which the first property is received in the intercorporate liquidation and ending with the day of its completion; and the extent to which, and the conditions and limitations under which, such rules are to be applicable.

(26 U. S. C. 1946 ed., Sec. 761.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 113 (b)–1. *Adjusted basis: General rule.*—The adjusted basis for determining

the gain or loss from the sale or other disposition of property, is the cost of such property or, in the case of such property as is described in paragraphs (1) to (16), inclusive, of section 113 (a), the basis therein provided, adjusted to the extent provided in section 113 (b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *

* * * * *

Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

* * * * *

ART. 115–3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are

brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. * * *

* * * * * *

ART. 115–11. *Effect on earnings or profits on certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning be-

fore January 1, 1936, or on or after such date) in exchange for its stock or securities, (see section 112 (b) (3)),

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

* * * * *

Treasury Regulations 101, promulgated under e Revenue Act of 1938:

ART. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received

other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1938, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under circumstances described in section 112 (b) (6) of the Revenue Act of 1936 or section 112 (b) (6) of the Revenue Act of 1938.

(3) The distribution in any taxable year (beginning after December 31, 1937) of

stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

* * * * *

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No. 83

In the Supreme Court of the United States

OCTOBER TERM, 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

In the Supreme Court of the United States

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MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

The taxpayer's brief contains a series of hypothetical examples designed to show that application of the *Sansome* principle to work an inheritance of earnings and profits as such but not to permit a carry-over of deficits as such leads to results which comport neither with sound corporate accounting nor economic reality (Br. 19–28). Before discussing these examples in any detail, we should like, once again, to make reference to some basic factors which the taxpayer seems to ignore.

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First: To note an inconsistency between tax treatment and corporate accounting concepts in this field, as does the taxpayer, is to advance her position not at all. As this Court has but recently said: "'earnings and profits' in the tax sense, although it does not correspond exactly to taxable income, 'does not necessarily follow corporate accounting concepts either.'" *Commissioner* v. *Wheeler*, 324 U. S. 542, 546; rehearing denied, 325 U. S. 892. If the *Sansome* rule means anything, it must involve the expectation that any attempt at translating its effect on application into traditional or standard accounting terms will often lead to disappointment. For the *Sansome* rule almost always has the effect of treating as "earnings and profits" available for distribution as a taxable dividend amounts which have been capitalized on the books of the new corporation and, against which, as an accounting matter, there is a capital stock liability. See, *e. g. United States* v. *Kauffman*, 62 F. 2d 1045, 1046 (C. C. A. 9th); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642 (C. C. A. 5th); *Barnes* v. *United States*, 22 F. Supp. 282, 283 (E. D. Pa.), per Maris, D. J.

Seconds The taxpayer attempts (Br. 28) to measure the validity of the Commissioner's restriction of the *Sansome* rule to air "earnings and

profits situation against a standard of economic reality. But to make this attempt by dealing only with the effect of this application of the *Sansome* rule on the corporation itself is a doubtful approach generally, and entirely beside the point when, as here, the taxpayer with whose interests this case is concerned is the shareholder, not the corporation.

If we are to speak in terms of "true economic status" (Br. 28), the following facts cannot be ignored. In this case, it is conceded that the corporation of which the taxpayer was a shareholder had accumulated earnings in excess of $2,000,000. After deducting that part of the distribution during the taxable year which was concededly out of current earnings, the amount of the distribution in issue is only $411,896.98. Nothing could be farther from "economic reality" than to conclude that while there were over $2,000,000 in earnings and profits available for distribution, a distribution of about $400,000 was not out of earnings and profits even though the shareholders' corporation had suffered no operating losses of its own and had made no other distributions. If the corporation in which the taxpayer held stock suffered a loss on the liquidations, that is not shown. The realities of the situation thus are that nothing has cut into the accumulated earn-

ings of over $2,000,000 other than, according to the taxpayer, a paper deficit of four corporations in which the taxpayer held no stock.

If the taxpayer's corporation has suffered a loss in an economically "real sense", though one which is not recognized for tax purposes, that loss will be reflected in the value of her stock, and she will, in a very real tax sense, be credited with that loss on ultimate disposition of her stock. See, our principal brief, pp. 39–40.

With these considerations in mind, we turn now to a detailed analysis of the taxpayer's hypotheticals:

A. The fact that the application of the *Sansome* rule even to a situation not involving a predecessor corporation with a deficit will upset the corporate balance sheet may well be illustrated by adopting the first hypothetical case assumed by the taxpayer (Br. 19–20). Corporations A and B have the following balance sheets:

	A	B
Net Assets	$125,000	$75,000
Capital stock	$100,000	$50,000
Earned surplus account	25,000	25,000
	$125,000	$75,000

Assuming that B, in a tax-free merger, is to acquire the assets of A of a value of $125,000 in exchange for its stock, B would, in the ordinary course, have to issue stock in the amount of at least $125,-

000.[1] The balance sheet of B after the acquisition, for accounting purposes, would then be as follows:

Assets	$200,000
Capital stock	225,000
Earned surplus	(25,000)
	$200,000

But under the *Sansome* rule, for tax purposes, the A earnings of $25,000 (reflected in the value of the A assets transferred) would remain earnings in B's hands and would eliminate its deficit, resulting in a zero amount for the earned surplus account. And if these transferred earnings were carried into the balance sheet, B's balance sheet as a consequence of the *Sansome* rule would be unbalanced, reflecting assets of $200,000 and capital stock of $225,000. To show the corporation's position for tax purposes, the balance sheet would have to be reconstructed further, by reducing the capital stock account by the amount of the *Sansome* earnings. For the purposes of getting a tax balance sheet, there could of course be no objection to this step since the *Sansome* rule regards so much of the capital stock shown on B's books as equals the former accumulated earnings of A

[1] The taxpayer's assumption (Br. 20) that, regardless of whether B is merged into A or A into B, the combined capital stock would be $200,000 is we believe, not correct. In the usual business transaction, the stock issued for the assets would normally reflect the value of the assets so acquired. On this basis, the capital stock would not be $200,000 after either merger.

as, in fact, constituting earnings in B's hands despite their capitalization on its books.[2]

It is thus clear that the transfer of accumulated earnings worked by the *Sansome* rule can not be fitted into balance sheet concepts without further adjustments, and, by the same token, balance sheet concepts should not be a factor in determining whether a deficit is to carry over for tax purposes.

B. The taxpayer is mistaken in her suggestion that an inaccurate reflection of gains or losses arises only by virtue of a failure to carry over deficits. This difficulty is inherent in the *San-*

[2] If B were merged into A, A would acquire for $75,000 of its stock the B assets having a value of $75,000. A would then have $200,000 of assets, $175,000 of capital stock and an earned surplus of $25,000. These balance sheet figures would also be the figures for tax purposes, since the B deficit of $25,000, which was not reflected in the value of the assets which A received, does not pass to A. To carry over the deficit would upset the balance sheet.

Contrary to the taxpayer's assertion (Br. 19–20), it does make a difference in so far as the *Sansome* rule is concerned whether B is merged into A or A into B. The problem is to ascertain after each merger for tax purposes the amount in the earned surplus account of the particular corporation which acquired the other's assets. Cf. our principal brief, pp. 44–47. Where B acquires A's assets, B takes assets which in A's hands reflected capital in part and accumulated earnings in part and they continue to have the same status in B's hands in order to insure that the A earnings will not escape taxation as a dividend. This is so even though B has issued stock in the full amount of the assets acquired. On the other hand, if A were to acquire the assets of B, all of the assets would in B's hands have represented capital and they continue to represent capital in A's hands, stock having been issued in the amount of the assets.

some rule even when applied only to situations in which there is no deficit corporation. Thus, the taxpayer sets forth hypothetical cases (Br. 21–28) designed to illustrate her contention that the *Sansome* rule must be applied to deficits as well as earnings in order to reflect the actual but nonrecognizable gain or loss sustained by a parent on liquidation of a subsidiary. But these can be matched with other supposed cases which will show that the reflection of actual gains in the earnings account is not necessarily achieved by the operation of the *Sansome* rule. For example, assume that P company, with cash of $500,000 and capital stock of $500,000, purchases for business reasons the stock of A corporation, originally issued for $200,000, after A has earned $300,000. P in the normal course would pay $500,000 for the A stock. P's balance sheet would then show as an asset stock of A at $500,000 and capital stock of $500,000. P then liquidates A, taking over its assets at a basis of $500,000 and sustaining no gain or loss on the liquidation. Its balance sheet will still show assets (acquired from A) of $500,000 and capital stock of $500,000. Upon disposition of the assets P's actual gain or loss at that time will be recognized and carried into its earned surplus account. Yet notwithstanding that there was no gain or loss on the liquidation and that P's full gain or loss on disposition of the assets will be reflected in its earnings account, the *Sansome* rule operates

to transfer the A earnings of $300,000 to P as earnings for tax purposes. The *Sansome* earnings will of course not appear in P's balance sheet as earnings but will be reflected there in the figure of $500,000 for the capital stock. The result of the *Sansome* rule on these facts is to attribute a gain to P which it does not in fact have.

Assume now that the P company, with cash of $500,000 and capital stock of $500,000, purchases the stock of B corporation, originally issued for $200,000, at a time when B has earned $100,000. P pays $300,000 for the B stock. Thereafter, B earns $100,000 more and P liquidates B, taking over its assets at a basis of $400,000. P has a gain of $100,000 on the liquidation which is not recognized at the time and which will not be taken into account when the assets are disposed of since their basis is $400,000 instead of the $300,000 invested by P. For tax purposes P will, under the *Sansome* rule, be required to treat the former B earnings of $200,000 as its earnings; thus P's earnings for tax purposes increase by $200,000 whereas its gain was only $100,000.[3] Obviously, here too, the *Sansome*

[3] P's balance sheet will reflect the gain but not the *Sansome* transfer as follows:

Assets		*Net Worth*	
Cash	$200,000	Capital stock	$500,000
B assets	400,000	Earned surplus (gain on liquidation)	100,000
	$600,000		$600,000

rule does not correct P's earned surplus account so that it reflects P's actual but nonrecognized gain on the liquidation.

Third, it will be assumed that P, with cash of $500,000 and capital stock of $500,000, purchases the stock of C, originally issued for $200,000, at a time when C has earned $200,000. P is able to make the purchase at a bargain price of $200,000. Thereafter P liquidates C, taking its assets at a basis of $400,000 and realizing a gain of $200,000, which is unrecognized for tax purposes and which will not be reflected in the earned surplus account when the assets, having a $400,000 basis, are disposed of. That gain, though not recognized for tax purposes, will, however, appear as earned surplus on P's balance sheet. At the same time, the *Sansome* rule will transfer C's earnings of $200,000 to P for tax purposes, with the result that P's earned surplus account for tax and for balance sheet purposes will be the same. This result is reached not because the *Sansome* rule is constructed to reflect P's gain; the identity of tax and accounting results is merely a consequence of the particular figures selected.

C. The taxpayer's suggestion that proper accounting and equitable tax treatment can be guaranteed if successor corporations are permitted to inherit the deficits of its predecessors (Br. 28) is an erroneous one. Assume that P, with cash of $500,000 and capital stock of $500,000, buys the

stock of D, originally issued for $500,000, at a time when D has a deficit of $400,000. P pays $100,000 for the D stock and thereafter liquidates D, receiving assets of a value and at a basis of $100,000 and sustaining no gain or loss on the transaction. There is thus no unrecognized gain or loss, which will be unaccounted for when the assets are disposed of. However, if, contrary to our contention, the B deficit of $400,000 is considered to have been transferred to P, for tax purposes P will have a deficit in that amount even though it has in fact sustained no loss. This of course would not reflect the "true economic status" and is not warranted for any other reason.

Again, assume the same facts in respect of corporations P and E, except that, after P acquires E's stock for $100,000, E earns $200,000, reducing its deficit to $200,000. Upon liquidation of E, P takes over assets of $300,000, realizing a gain of $200,000 which is unrecognized at the time and which will not be accounted for when the assets are disposed of since their basis in P's hands is $300,000. If, contrary to our contention, the E deficit of $200,000 carries over to P, for tax purposes P will show a deficit of $200,000 when in fact it has had a gain of $200,000. To permit the deficit transfer there would completely depart from the true economic situation.

It is believed that the foregoing examples are sufficient to show that the transfer of earnings

pursuant to the *Sansome* rule does not necessarily adjust the earnings account to reflect a gain, nonrecognizable for tax purposes but realized by the parent on liquidation of a subsidiary, although it may by coincidence do so in some cases. They also show that the transfer of a deficit, if that were authorized, would not necessarily adjust the surplus account to reflect a nonrecognizable but realized loss. It follows that the *Sansome* rule is not to be enlarged to transfer deficits on the theory that to do so will reflect the true economic realities for balance sheet purposes or for tax accounting purposes.[1]

The plain fact is that the purpose of the *Sansome* rule is not to adjust the earnings account to reflect an unrecognized gain sustained on a liquidation, but, as was shown in our principal brief (pp. 15–22), is to preserve the predecessor's earnings as earnings in the hands of the reorganized or parent corporation so that they will be taxed to

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[1] As pointed out in our principal brief (pp. 30, 32, 37), the stipulation in this case is insufficient to show whether the parent corporation sustained gain or loss on the liquidations of the five subsidiary corporations in 1936.

[2] The typical reorganization for *Sansome* rule purposes is that in which the A corporation, in exchange for assets of B corporation, issues its stock or securities to B corporation or to the B stockholders. It would be a rare case indeed if A were to realize a gain on such a transaction. The *Sansome* rule was developed to meet that situation, however, and these considerations cogently confirm the point that a purpose to adjust the earnings accounts to reflect an unrecognized gain played no part in the development of the *Sansome* rule.

stockholders upon their distribution. The rule has justification in the fact that, apart from any gain or loss on the transactions, the reorganized or liquidated corporation has received the predecessor's assets, some of which reflect the amount of its accrued earnings. As previously emphasized, the rule is not required in the case of a deficit corporation which has no earnings to escape tax, nor is there justification for treating the deficit as continuing in the successor corporation's hands, because none of the assets it receives from the predecessor reflect or represent the predecessor's deficit.

CONCLUSION

The judgment of the Court of Appeals should be reversed.

Respectfully submitted.

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No. 83

In the
Supreme Court of the United States
October Term 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

MARGARET R. PHIPPS, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF OF MARGARET R. PHIPPS, Respondent, IN OPPOSITION

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MARGARET R. PHIPPS, RESPONDENT

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF OF MARGARET R. PHIPPS, Respondent, IN OPPOSITION

The respondent, Margaret R. Phipps, under authority of Rule 38 of this Honorable Court, files this her brief in opposition to the petition of the Commissioner of Internal Revenue for writ of certiorari to review the judgment of the Circuit Court of Appeals for the Tenth Circuit entered in this case.

OPINIONS BELOW

The opinion of the Tax Court (R. 13-23) is reported at 8 T. C. 190, and the opinion of the Circuit Court of Appeals (R. 30-37) is reported at 167 Fed. (2d) 117.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 10, 1948 (R. 38). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

This case involves a liquidation by a parent corporation of five wholly-owned subsidiaries, four of which had deficits in their earnings and profits accounts, and one of which had a surplus, as of the date of liquidation. The question is whether, on the one hand, the earnings and profits accounts of all five liquidated subsidiaries should be combined in the parent's earnings and profits account, or whether, on the other hand, the surplus of one subsidiary should be included, but the deficits of the other four should be excluded, in determining the earnings and profits of the parent after such liquidation.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix to Petitioner's Brief, pp. 16-18.

STATEMENT

In 1937, the Respondent received cash distributions from the Nevada-California Electric Corporation upon stock owned by her, in the total amount of $18,480.00, of which $8,992.28 was paid out of current earnings for the year 1937. This payment, together with corresponding payments to other stockholders, absorbed the entire earnings and profits for the year 1937. The question is whether or not the remainder of $9,487.72, which was not paid out of current earnings, was a taxable dividend. (R. 11)

On December 1, 1936, the Nevada-California Electric Corporation completely liquidated five wholly-owned subsidiary corporations, the liquidations being ones upon which no gain or loss was recognized under I. R. C. Section

112(b)(6). On such date the subsidiaries had earnings and profits accumulated since February 28, 1913, as follows (R. 11-12):

	ACCUMULATED EARNINGS AND PROFITS	
	(Deficit)	(Surplus)
Cain Irrigation Co.	1,740,592.54	
Hillside Water Co.	246,575.75	
The Southern Sierras Power Co.	1,094,697.86	
Yuma Utilities Co.	65,937.47	
The Nevada-California Power Co.		90,362.77

As of December 31, 1936, the parent company had accumulated earnings and profits (since February 28, 1913) in the amount of $2,129,957.81 computed without regard to the accumulated earnings and profits (whether surplus or deficit) of the liquidated subsidiaries, without regard to gain or loss to the parent upon such liquidations, and without regard to prior operating profits or losses of such subsidiaries (R. 12).

If as a result of the tax-free liquidation of the five above listed subsidiaries the accumulated earnings and profits of the parent as of December 31, 1936, cannot be reduced by the amount of the deficits of the other four subsidiaries, then the parent would have a surplus at the beginning of 1937 available for payment of dividends and the sum of $9,487.72 paid to respondent (and similar payments to other stockholders) would constitute a taxable dividend. This is the contention of the Commissioner, the Petitioner herein.

But if the earnings and profits accounts of the parent and the five liquidated subsidiaries must be combined in that account of the parent, i.e., the surplus of the one subsidiary credited and the deficits of the four charged to the parent's accumulated earnings and profits account, then on December 31, 1936, the parent company would not have any surplus in accumulated earnings and profits, but would have a deficit. If this be so, then the sum of $9,487.72 paid to respondent was paid neither out of current earnings for 1937 nor out of accumulated earnings and hence was not a taxable

dividend, but was a payment out of the corporation's capital. This is the contention of the taxpayer, the respondent herein, and the Tax Court (R. 23) and the Circuit Court of Appeals (R. 32) so held.

SPECIFICATION OF ERROR

The respondent contends that no error was committed by the Circuit Court of Appeals in affirming the decision of the Tax Court and in holding that in the case of the liquidation of five wholly-owned subsidiaries under section 112(b)(6) of the Internal Revenue Code, the earnings and profits of the liquidated companies, whether consisting of credit balances or deficits, should be reflected in the earnings and profits account of the parent company and should be taken into account in determining whether distributions subsequently made to stockholders by the parent company were paid out of earnings and profits or out of capital.

REASONS FOR DENYING THE WRIT

1. There is no existing conflict between decisions of Circuit Courts of Appeals for different circuits. The decision of the Circuit Court of Appeals in the case at bar is in harmony with the decisions of the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Sansome*, 60 Fed. (2d) 931, certiorari denied, 287 U. S. 667, and *Harter v. Helvering*, 79 Fed. (2d) 12, and decisions of other Circuit Courts of Appeal since those were rendered; and is not in conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit in *Cranson v. United States*, 146 Fed. (2d) 871, certiorari denied, 326 U. S. 717.

The decision of the Circuit Court of Appeals in the case at bar states the rule of law known as the "Sansome" rule and its application to this case as follows (R. 31-32):

> "In a tax-free reorganization of corporations where a parent liquidates a wholly owned subsidiary, taking over its assets subject to their liabilities in complete cancellation and redemption of its issued and outstanding capital stock, or where two corporations merge, the entire corporate life survives as a continued venture insofar as tax consequences are concerned. A transaction of that kind does not pro-

duce any change in respect of tax purposes, the successor being merely the continuation of the predecessor.

"The principle is not a narrow one, limited to accumulated earnings or profits of the liquidated or absorbed company. It includes a deficit in the earnings or profits account of such company. The earnings and profits accounts of the transferor company, whether consisting of credit balances or deficits, should be reflected in the corresponding accounts of the transferee company and should be taken into account in determining whether distributions subsequently made to stockholders of the emerged company were paid out of earnings or profits or out of capital."

This is the principle enunciated by Judge Learned Hand in the cases of *Commissioner v. Sansome* (1932) *supra*, and *Harter v. Helvering* (1935), *supra*.

In the *Sansome* case, A Company sold out all its assets to B Company, both organized under the laws of New Jersey; the new company assumed all liabilities and issued its stock to the stockholders of A Company. The only change was that the new company's charter gave it broader powers. The latter made no profits and declared a dividend, claimed to be a liquidating dividend, but the court held that since the transaction was non-taxable under Section 202(c)(2) of the Revenue Act of 1921, one of the so-called reorganization provisions of the statute, the identity of the enterprise continued unchanged by the reorganization with the result that the surplus in earnings and profits of the old company remained as surplus in earnings and profits available for dividends. The Court said (p. 933):

"'Hence we hold that a *corporate reorganization which results in no 'gain or loss' . . . does not toll the company's life as continued venture* under section 201 and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation.' (Emphasis ours).

In the *Harter* case there were two separate reorganizations. The first reorganization was a merger of Philadel-

phia Paper Manufacturing Company and Fibre Container Company, each of which had a surplus in its earnings and profits account. The emerging corporation was named New Company. As to this merger, the opinion states (p. 13):

> "When the Philadelphia Paper Manufacturing Company and the Fibre Container Company merged on June 30, 1923, no gain was 'recognized' to the shareholders, for it was a 'reorganization' under section 202(c)(2) of the Revenue Act of 1921 (42 Stat. 229), and section 203(b)(2) of the Revenue Act of 1926, 26 USCA Sec. 934 (b)(2). A consequence of this is that for purposes of allocating dividends under section 201(b) of the Revenue Act of 1926, 26 USCA Sec. 932(b), against earnings before and after March 1, 1913, the surplus is regarded as unchanged. The Commissioner proceeded on the assumption that the shares issued by the New Company, $3,164,750, 'impounded' a corresponding amount of surplus and left for distribution as dividend only the bookkeeping surplus, $1,692,384.34. We have decided otherwise, Commissioner v. Sansome, 60 F. (2d) 931, and the Ninth Circuit agrees. U.S. v. Kauffman, 62 F. (2d) 1045. *Thus the surplus of the New Company was the difference between the assets of both the old companies and the capital shares of both . . .*" (Emphasis ours).

The second reorganization involved in the case was a consolidation of New Company with Boxboard Company. New Company had a substantial surplus in its earnings and profits account but Boxboard had a deficit of $17,388.95. The Court held that upon the merger of New Company and Boxboard Company, the earnings and profits account of the emerging company, which was Boxboard, was not the surplus of New Company undiminished by the deficit of Boxboard Company, but was the contrary, i.e., the surplus of New Company reduced by the deficit of Boxboard Company. Referring to the last sentence in the above quotation from its opinion, the Court expressly pointed out the manner in which this result was reached (p. 13):

> "*Again when in April 1926, the New Company consolidated with the Boxboard Company, the same result ensued, . . .*" (Emphasis ours).

Hence, in the *Harter* case the Court held, as to the first reorganization, that the surplus of the emerging new company was the difference between the assets of both the old companies and the capital shares of both. Then, as to the second reorganization, the Court expressly declared in applying the "Sansome" principle to a merger of a surplus company and a *deficit* company, *the same result ensued* as in the case of merger of surplus companies, to-wit: the successor or emerging company has assets consisting of the total of both companies' assets, and has a surplus or deficit in its earnings and profits account determined by subtracting the combined capital from the combined assets.* As a result of this rule, each constituent company's earnings and profits account continues to exist in the corresponding account of the emerging company,—a surplus in the earnings and profits account is not converted into additional capital, nor is a deficit in the earnings and profits account eliminated by a reduction of capital. This is the so-called "Sansome" rule, and it was followed by the Circuit Court of Appeals in the case at bar.

The decision in the *Cranson* case, *supra*, is not at variance with the foregoing, as both the Circuit Court of Appeals (R. 32) and the Tax Court (R. 21) held in the case at bar.

In the *Cranson* case, a parent company (The Honolulu Oil Corporation, Ltd.) liquidated (tax-free) three wholly owned subsidiaries on August 31, 1936, when the subsidiaries had substantial deficits.

The statute involved in the *Cranson* case was the same as in the case at bar—the Revenue Act of 1936. Section 115(a)(b) (Appendix to Petitioner's Brief, 17) of that Act.

---

*The Court's computations are more fully visualized when set forth in table form as follows:

	Net Assets		Capital		Earnings & Profits
New Company (before merger)	$a	minus	$x	equals	$4,307,134.34 (surplus)
Boxboard Company (before merger)	$b	minus	$y	equals	(17,388.95) (deficit)
One Company (Upon merger)	$(a+b)	minus	$(x+y)	equals	$4,289,745.39 (surplus)

provides that corporate distributions shall be considered as paid first from the earnings of the current year, and then from earnings accumulated since February 28, 1913. To the extent that there are net earnings of the current year, the distribution is a taxable dividend, even though there are no accumulated earnings from prior years, or even if there is a deficit in prior years. In the case at bar this was recognized and the taxpayer conceded (R. 11) and the Tax Court found as a fact (R. 14), that the distributions in the year 1937 were taxable to the extent of the earnings of that year. In the case at bar the sole issue is the effect of the subsidiaries' deficits upon *accumulated* earnings and profits. In the *Cranson* case, however, the taxpayer insisted that the deficits of the subsidiaries should be applied to reduce not the *accumulated* earnings prior to 1936, but the *current* earnings of 1936.

The Court said (p. 871):

> "If Honolulu itself had at the beginning of 1936 the same operating deficit, the deficit could not have been deducted."

and later in the opinion (p. 872):

> "The equation of operating deficit for tax purposes is the loss sustained within the taxable year. As to the alternative contention of the appellant here that if the operating deficits do not diminish the earnings, the losses sustained in the liquidation would diminish earnings, there has been no showing that any of the loss was incurred in the tax year in question. Furthermore, it is apparent that appellent has not maintained its burden of proof that any of the deficits occurred in the tax year 1936. * * * It is hence not before us to consider whether any such deficits would be deductible from the profits of the parent corporation if they had occurred in the tax year 1936.
>
> "Whether or not the parent company suffered losses in the tax years prior to 1936, if there be corporate earnings or profit in that year the Revenue Act of 1936 provides that distributions to the stockholders in that year are deemed to be from its most recently accumulated earnings or profits for that year, without regard to the fact that they are earned

> in that portion of the year after the distribution was made."

It is obvious, therefore, that the Court and the parties were addressing themselves to the question as to whether the deficits of the subsidiaries were deductible from *current* earnings of the year in which the distributions were made.* That question is not involved in the case at bar and was not passed upon by the Tenth Circuit Court of Appeals in its decision in the case at bar.

Petitioner therefore submits that there is no conflict between the case at bar and the *Cranson* case.

Furthermore, the decision in the case at bar is in harmony not only with the decisions of the Circuit Court of Appeals for the Second Circuit in the *Sansome* and *Haxter* cases, but with other decisions applying the "Sansome" rule in the Fourth, Sixth, and Ninth Circuits. The following cases involved tax-free corporate reorganizations or liquidations within the meaning of the Internal Revenue Code or applicable Revenue Acts:

United States v. Kauffman, (CCA 9th, 1933) 62 Fed. (2d) 1045, 1047:

> "In that case (Sansome) it was held that a reorganization of a corporation, * * * wherein the stock-

* Petitioner states (Pet. Br. P. 6) that the total dividend paid by the parent in 1936 amounted to $937,743, and argues that the distribution in 1936 exceeded the 1936 current earnings of $931,553.32 by $6,189.19, and that, as to the latter amount (i.e., 66/100 of 1% of the distribution), the distribution could have been held a dividend only if the parent's accumulated earnings prior to 1936 were not affected by the subsidiaries' deficits. On the basis of this 66/100 of 1% (which as to Mr. Cranson amounted to $2.97) petitioner argues that the court to that extent rendered a decision in conflict with the case at bar. The figure of $937,743 as the amount of the dividend is not mentioned in the decision of the Circuit Court of Appeals in the *Cranson* case, and petitioner ascertains the amount by reference to the record in the case of *Lorin A. Cranson v. United States of America*, No. 85, October Term, 1944, of this Court, which is not part of the record of the case at bar. Reference to the briefs in Case No. 85 discloses, however, that the entire argument was centered on the question of the right to deduct the deficit of the subsidiaries from the *current* earnings of the parent company for 1936 and no reference was made to the question involved in the case at bar.

holders were not taxable for a gain or loss * * * was not such a change in corporate identity as prevented the new company from being *considered as a continuing venture.* * * *." (Emphasis ours):

Gordon Enterprises, Ltd. v. Commissioner, (CCA 4th, 1942), 126 Fed. (2d) 384, 389:

> "The meat of the Sansome case is found in a statement by Circuit Judge Learned Hand * * * 'Hence, we hold that a corporate reorganization which results in no "gain or loss" * * * does not toll the company's life as continued venture.' * * *"

Reed Drug Co. v. Commissioner, (CCA 6th, 1942), 130 Fed. (2d) 288, 290:

> "Such corporate transactions * * *, do not break the continuity of the corporate life."

Robinette v. Commissioner, (CCA 9th, 1945), 148 Fed. (2d) 513, 516:

> "The earnings and profits of Cole-French Company, in existence when liquidation occurred, did not disappear. Either the subsidiary or the parent company had them. * * * The parent completely took over the subsidiary. There is *complete identity* of the corporations." (Emphasis ours).

The foregoing review of the cases decided by the several Circuit Courts of Appeals including that for the Ninth Circuit in the *Cranson* case, and that of the Tenth Circuit Court of Appeals in the case at bar, shows that they all recognize that the underlying theory of the "Sansome" rule is that of the continuity of the corporate existence, and that such continuity requires the merging of the several individual capital accounts and the several individual earnings and profits accounts of the predecessors and parent, or the constituent companies, whether or not the earnings and profits accounts show surpluses or deficits. There is no conflict among the decisions of these Courts.

2. The decision of the Circuit Court of Appeals in the case at bar does not apply the "Sansome" rule in violation of the reasoning of the decisions of this Court.

Petitioner cites only *Commissioner v. Munter*, 331 U.S. 210, in support of his claim that the Circuit Court of Appeals misapplied the "Sansome" rule. In holding that the "Sansome" rule applied to a complicated transaction, the facts of which are not pertinent in the case at bar, the Court said in that case (p. 213):

> "Relying upon the rule of *Commissioner v. Sansome*, 60 F. (2d) 931, *which, for tax purposes, treats a reorganized corporation as but a continuation of its predecessors*, the Tax Court determined that the new corporation acquired all the earnings and profits of its predecessors in 1928." (Emphasis ours).

And at page 215:

> "Congress has repeatedly expressed its approval of the so-called *Sansome* rule as a correct interpretation of the purpose of the tax laws governing reorganizations."

In the case of *Commissioner v. Wheeler*, 324 U.S. 542 (rehearing denied, 325 U.S. 892), this Court had previously stated the Congressional policy which produced the reorganization provisions of the tax laws, and pointed out that the theory of the "Sansome" rule was "sensible," saying (p. 546):

> "'Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income tax liability but shall be taken account of later. Secs. 112, 113. *It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits.* Compare *Commissioner v. Sansome*, 60 F. (2d) 931. * * *'" (Emphasis ours).

The use of corporate reorganizations in the early years of the income tax laws to bring about realizations of losses and gains which were, in a sense, artificially produced and not the natural result of the operation of the business involved, was realized by Congress and it decided to discourage manipulations of this type by requiring the participants to postpone any tax effect (advantageous or otherwise) un-

til some event (such as sale of assets) produced a loss or gain which could be accepted as in the normal course of the business of the entire enterprise.

For that reason Congress said that in such transactions neither loss nor gain should be recognized at the time the transaction occurred, and emphasized the factor of continuity of the business venture by providing that the assets of the liquidating company should be set up on the books of the acquiring company at the same tax basis as appeared on the books of the liquidating company. When the acquiring company sold the assets in the future it would incur the same amount of loss or gain as the liquidating company would have incurred had it retained the assets itself; and that amount of loss or gain would at that time be entered in the earnings and profits account.

But the "Sansome" rule recognizes the fact that the provision made by Congress for accounting for loss or gain on the sale of the assets of the group involved in the business venture as though the inter-corporate transactions had not occurred, made no provision for the disposition of the earnings or losses made or suffered in the management and operation of these assets. The "Sansome" rule preserves consistency in the tax treatment of the entire enterprise in requiring the assets of the liquidating company to go over to the acquiring corporation without tax effect, requiring that the capital go over unchanged, and that earnings and profits (whether surplus or deficit) should go over unchanged.

The words "earnings and profits" refer merely to an account; the word "deficit" refers merely to a minus balance in that account; and the word "surplus" connotes simply a plus balance in such account.* Neither the capital account

* In the *Wheeler* case, *supra*, this Court commented on the meaning of the term "earnings and profits," and pointed out that both losses and gains enter into their computation. It follows that losses may exceed gains and the "earnings and profits" account may show a deficit. The *Hazlet* case, *supra*, and the *Senior* case, *infra*, both applying the "Sansome" rule, show that the term "earnings and profits" refers to an account by that name which may or may not have a credit balance or surplus.

nor the earnings and profits account of a corporation stands for or represents any specific assets or any specific property.

The capital account reflects that portion of a company's total assets which is represented by the funds paid in by contributing stockholders as "capital." For tax purposes a corporation's capital as reflected by its capital account remains constant (except as it is increased by contributions from, or decreased by distributions to, its stockholders). The gains or losses of the corporation do not increase or decrease "capital."

The earnings and profits account reflects the difference between the corporation's net assets (i.e. assets minus liabilities) and its capital. Thus the earnings and profits account of a corporation is the balancing figure in an equation. The equation is: net assets (i.e. assets reduced by liabilities) equals capital plus earnings and profits. A company's net assets must always be exactly equal to its capital plus its earnings and profits. This is of necessity so because "capital" and "earnings and profits" are merely tax and accounting expressions used to show how much of total net assets is represented by capital contributed and how much is represented by earnings and profits accumulated.

A corporation which has sustained operating losses sufficiently great so that its net assets are less than its capital, thus has a deficit in earnings and profits. Such a corporation does not have any accumulated earnings and profits out of which dividends can be paid until it realizes sufficient earnings to restore such deficit.*

---

* "MEANING OF "ACCUMULATED EARNINGS OR PROFITS." The statute includes in the term 'dividend' not only distributions out of current earnings or profits, but also distributions out of 'accumulated' earnings or profits (since February 28, 1913). Accordingly, prior to the 1936 Act, any distribution, and since the 1936 Act, the excess of distribution over current earnings, is a taxable dividend only if there exist earnings or profits accumulated after February 28, 1913 . . . *An impairment of fixed or statutory capital occasioned by a deficit must be restored out of subsequent earnings before there can be accumulated earnings or profits available for dividends. The same rule governs impairments of capital surplus or paid-in surplus.*" (Emphasis ours). Mertens, Law of Federal Income Taxation, Vol. 1, Sec. 9.30, p. 461.

Eliminating the deficits in computing for tax purposes the earnings and profits account of the successor would mean that for tax purposes the capital investment in the entire venture is reduced by the amount of the deficit eliminated. Four of the five liquidated subsidiaries in the case at bar had substantial operating deficits. Had those subsidiaries not been liquidated but continued as separate corporations, each of them would have been permitted under the tax laws to earn and retain sufficient profits to eliminate the respective deficits. The effect of the lower court's decision is simply that the tax-free liquidation does not reduce the capital, which tax-wise is regarded as invested in such companies before the reorganization, or alter or change the aggregate balance in the earnings and profits accounts of the constituent companies. Upon a tax-free liquidation or reorganization, the entire corporate venture must be viewed as a whole and as so viewed, the combined assets of such venture must represent capital to the extent of the capital that existed before the tax-free transaction and will represent a surplus of accumulated earnings and profits only if such assets exceed such capital.

This was the holding of the court below and, when viewed in the light of the foregoing discussion of the meaning and effect of the "Sansome" rule, the decision is in harmony with the rationale of the decisions of this Court in the *Munter* and *Wheeler* cases.

3. Since the underlying principle of the "Sansome" rule has been settled by decisions of the several Circuit Courts of Appeals which are not in conflict with one another and which are in harmony with the decisions of this court, review by this Court is unnecessary.

The principle of the "Sansome" rule has been recognized by this Court in *Commissioner v. Munter*, *supra*, and *Commissioner v. Wheeler*, *supra*, and adopted by many of the Circuit Courts of Appeals and the Tax Court, as shown in the preceding sections of this brief. Until the case at bar was brought, we have found no record of the refusal of the Commissioner to apply the "Sansome" rule to a deficit case. On the contrary, the Commissioner acquiesced in its applica-

tion in the case of *Senior Investment Corporation v. Commissioner* (1943), 2 T. C. 124, involving a tax-free split-off reorganization. There the Commissioner agreed before the Tax Court that the deficit of a predecessor company should be allocated in a reorganization proceeding and only contended that the amount allocable to the successor corporation was insufficient.

In that case the Tax Court said (p. 137):

> "It is the rule that, where the assets of one corporation pass to a successor corporation in a tax-free reorganization, the accumulated earnings and profits of the old corporation pass to the successor *with the same status* and are available for the payment of dividends by the latter, Commissioner v. Sansome, 60 Fed. (2d) 931; certiorari denied 287 U. S. 667; United States v. Kauffman, 68 Fed. (2d) 1045; Reed Drug Co. v. Commissioner, 130 Fed. (2d) 288; Helen V. Crocker, 29 B.T.A. 773; and that where only part of the assets are so transferred, it is proper to make an allocation of the earnings and profits between the two corporations in proportion to the assets transferred and the assets retained.
>
> "The Respondent (Commissioner) questions the Petitioner's claim that it is a deficit corporation; *but he makes no contention that the principles of the foregoing cases do not apply to the inheritance or absorption of a deficit.* * * *" (Emphasis ours).

Petitioner's suggestion that the decision of the Court below may possibly in future instances lead to tax avoidance does not justify the granting of the writ. This Court itself has laid down the rules which would control attempts

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* Cf. *Helen V. Crocker v. Commissioner*, 29 B.T.A. 773, where the Tax Court said:

> "It is also true that it is merely stipulated that the surplus of the three (predecessor corporations) was sufficient to pay the dividends so that it may be that one of them had a deficit. * * * But we do not think that such a fact, even if true, makes any difference. If the *successor corporation had a surplus inherited from all its predecessors sufficient to pay the dividends, it matters not in what proportions it was contributed.* Such is the effect of our decision in *George F. Baker, Jr., Executor*, 28 B.T.A. 704." (Emphasis ours).

to evade taxes. The purchase of a deficit corporation by a corporation having a surplus for the purpose of liquidating it and offsetting the deficit against the surplus would be defeated by the "business purpose" requirements of such cases as—

Gregory v. Helvering, 293 U. S. 465.
Bazley v. Commissioner, 331 U. S. 737.
Helvering v. Elkhorn Coal Co. (C.C.A. 4) 95 Fed. (2d) 732, certiorari denied, 305 U. S. 605, 670.

In the case at bar there is no suggestion that the motive for liquidation was to avoid taxes, or that the subsidiary companies were acquired for that purpose, or that there was anything except a sound business purpose for the liquidation of the five subsidiaries.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be denied.

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No. 83

In the Supreme Court of the United States

October Term 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

MARGARET R. PHIPPS, RESPONDENT

CERTIORARI TO
THE UNITED STATES CIRCUIT COURT OF
APPEALS FOR THE TENTH CIRCUIT

BRIEF OF MARGARET R. PHIPPS, Respondent.

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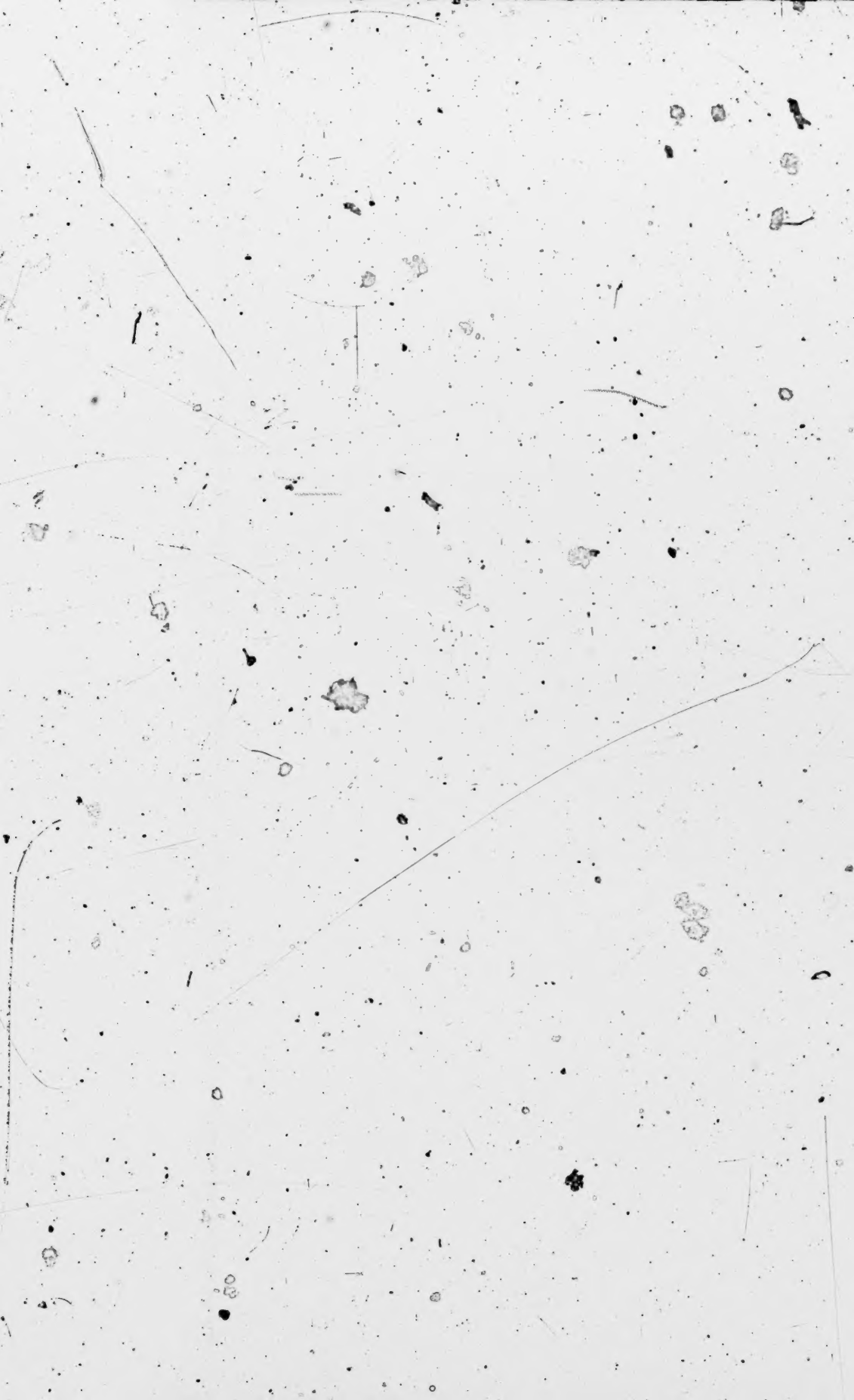

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In the

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No. 83

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

MARGARET R. PHIPPS, RESPONDENT

CERTIORARI TO
THE UNITED STATES CIRCUIT COURT OF
APPEALS FOR THE TENTH CIRCUIT

BRIEF OF MARGARET R. PHIPPS, Respondent.

The respondent, Margaret R. Phipps, under authority of the rules of this Honorable Court, files this her brief on certiorari to review the judgment of the Circuit Court of Appeals for the Tenth Circuit entered in this case.

OPINIONS BELOW

The opinion of the Tax Court. (R. 13-23) is reported at 8 T. C. 190, and the opinion of the Circuit Court of Appeals (R. 30-37) is reported at 167 F. 2d 117. Certiorari was granted by this Court on October 11, 1948.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on March 19, 1948 (R. 38). The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

STATEMENT OF THE CASE

In 1937, the Respondent received cash distributions from the Nevada-California Electric Corporation upon stock owned by her, in the total amount of $18,480.00, of which $8,992.28 was paid out of current earnings for the year 1937. This payment, together with corresponding payments to other stockholders, absorbed the entire earnings and profits for the year 1937. The question is whether or not the remainder of $9,487.72, which was not paid out of current earnings, was a taxable dividend. (R. 10-11.)

On December 1, 1936, the Nevada-California Electric Corporation completely liquidated five wholly-owned subsidiary corporations, the liquidations being ones upon which no gain or loss was recognized under Section 112(b)(6) of the Revenue Act of 1936. On such date the subsidiaries had earnings and profits accumulated since February 28, 1913, as follows (R. 11-12):

	ACCUMULATED EARNINGS AND PROFITS	
	(Deficit)	(Surplus)
Cain Irrigation Co.	1,740,592.54	
Hillside Water Co.	246,575.75	
The Southern Sierras Power Co.	1,094,697.86	
Yuma Utilities Co.	65,937.47	
The Nevada-California Power Co.		90,362.77

As of December 31, 1936, the parent company had accumulated earnings and profits (since February 28, 1913) in the amount of $2,129,957.81 computed without regard to the accumulated earnings and profits (whether surplus or deficit) of the liquidated subsidiaries, without regard to gain or loss to the parent upon such liquidations, and without regard to prior operating profits or losses of such subsidiaries (R. 12).

If as a result of the tax-free liquidation of the five above listed subsidiaries the accumulated earnings and profits accounts of the parent and the one subsidiary as of December 31, 1936, cannot be reduced by the amount of the deficits in the earnings and profits accounts of the other four subsidiaries, then the parent would have had a surplus at the beginning of 1937 available for payment of dividends and the sum of $9,487.72 paid to respondent (and similar payments to other stockholders) would constitute a taxable dividend. This is the contention of the Commissioner, the Petitioner herein.

But if the earnings and profits accounts of the five liquidated subsidiaries must be combined with the corresponding account of the parent, i.e., the surplus of the one subsidiary credited and the deficits of the four charged to the parent's accumulated earnings and profits account, then on December 31, 1936, the parent company would not have had any surplus in accumulated earnings and profits, but would have had a deficit. If this be so, then the sum of $9,487.72 paid to respondent was paid neither out of current earnings for 1937 nor out of accumulated earnings and hence was not a taxable dividend, but was a payment out of the corporation's capital. This is the contention of the taxpayer, the respondent herein, and the Tax Court (R. 23)[1] and the Circuit Court of Appeals (R. 32) so held.

SUMMARY OF ARGUMENT

The sole issue in this case is whether, on the one hand, the earnings and profits accounts of all five liquidated subsidiaries should be combined with the parent's earnings and profits account, or whether, on the other hand, the surplus of one subsidiary should be included but the deficits of the other four should be excluded, in determining the earnings and profits of the parent after such liquidation.

[1] The fact that the decision of Judge Disney was not reviewed by the whole Tax Court does not affect the validity and authority of the decision as intimated by Petitioner. *Sisto Financial Corporation v. Commissioner*, 149 F. 2d 268; *Kennedy Name Plate Co. v. Commissioner*, (CCA-9, decided Oct. 28, 1948).

The principle (known as the *Sansome* rule) that a non-taxable reorganization or liquidation does not toll the lives of the constituent corporations as continued ventures, stated in *Commissioner vs. Sansome* (CCA-2, 1932), 60 F. 2d 931, certiorari denied, 287 U. S. 667, requires not only as a matter of law, but of sound income tax accounting, that the accounts of predecessor constituent corporations be combined and as so combined become the accounts of the emerging or parent corporation. With respect to the earnings and profits accounts of such predecessor companies it makes no difference whether these show a surplus or a deficit; the earnings and profits account of the emerging or parent company is the sum of all surpluses reduced by all deficits.

The correct application of the *Sansome* rule does not open the door to tax avoidance or evasion.

ARGUMENT

The use of corporate reorganizations in the early years of the income tax laws to bring about realizations of losses and gains which were, in a sense, artificially produced, and not the natural result of the operation of the business involved, was recognized by Congress and it decided to discourage manipulations of this type by requiring the participants to postpone any tax effect (advantageous or otherwise) until some event (such as sale of assets) produced a loss or gain which could be accepted as in the normal course of the business of the entire enterprise.

For that reason Congress said that in such transactions neither loss nor gain should be recognized at the time the transaction occurred, and emphasized the factor of continuity of the business venture by providing that the assets of the liquidating company should be set up on the books of the acquiring company at the same tax basis as appeared on the books of the liquidating comp . . . (Revenue Act of 1936, Sections 112(b)(6) and 113(a)(15).)[1] When the acquiring company sold the assets in the future it would incur

[1] Appendix, p. 43.

the same amount of loss or gain as the liquidating company would have incurred had it retained the assets itself, and that amount of loss or gain would at that time be entered in the earnings and profits account of the acquiring company.

But the *Sansome* rule recognizes the fact that the provision made by Congress for accounting for loss or gain on the sale of the assets of the group involved in the business venture as though the inter-corporate transactions had not occurred, made no provision for the disposition of the earnings or losses made or suffered in the management and operation of these assets. The *Sansome* rule preserves consistency in the tax treatment of the entire enterprise in requiring the assets of the liquidating company to go over to the acquiring corporation without tax effect, and that earnings and profits (whether surplus or deficit) should go over unchanged.

The rule is supported both by the courts and by the logic of sound income tax accounting principles.

1. Upon the liquidation of the five wholly-owned subsidiary corporations under section 112(b)(6) of the Revenue Act of 1936, the parent corporation, is, for income tax accounting purposes, considered a continuation of the liquidated companies, and the assets and earnings and profits accounts of the liquidated companies are transferred to and merged with the corresponding accounts of the parent.

This rule was first stated in a decision of Judge Learned Hand of the Second Circuit Court of Appeals in the case of *Commissioner v. Sansome* (July 26, 1932), 60 F. 2d 931, certiorari denied 287 U. S. 776.

In the *Sansome* case, A Company sold out all its assets to B Company, both organized under the laws of New Jersey; the new company assumed all liabilities and issued its stock to the stockholders of A Company. The only change was that the new company's charter gave it broader powers. The latter made no profits and declared a dividend, claimed to be a liquidating dividend, but the court held that since the transaction was non-taxable under Section 202(c)(2) of

the Revenue Act of 1921, one of the so-called reorganization provisions of the statute, the identity of the enterprise continued unchanged by the reorganization with the result that the surplus in earnings and profits of the old company remained as surplus in earnings and profits available for dividends. The Court said (p. 933):

> "Hence we hold that a *corporate reorganization which results in no 'gain or loss' . . . does not toll the company's life as continued venture* under section 201 and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation." (Emphasis ours).

The Supreme Court has approved this view of the *Sansome* rule:

Commissioner v. Munter (May 5, 1947) 331 U. S. 210, 213, 67 S. Ct. 1175, 1176[1]:

> "Relying upon the rule of *Commissioner v. Sansome*, 60 F. (2d) 931, *which, for tax purposes, treats a reorganized corporation as but a continuation of its predecessors*, the Tax Court determined that the new corporation acquired all the earnings and profits of its predecessors in 1928." (Emphasis ours.)

And at page 215:

> "Congress has repeatedly expressed its approval of the so-called *Sansome* rule as a correct interpretation of the purpose of the tax laws governing reorganizations."

Commissioner v. Wheeler (March 26, 1945) 324 U. S. 542, 546, 65 S. Ct. 799, 802:

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[1]The Circuit Court of Appeals had held that because of the introduction of new money and new stockholders the continuity of life of the venture had been destroyed so that the *Sansome* rule would not apply, citing Campbell v. United States, 144 F. 2d 177. The Supreme Court said: "We granted certiorari because of an alleged conflict with the *Sansome* rule. . . . In the state of the record we find it necessary to decide no more than whether the distinction of the *Sansome* rule made by the Campbell case is correct," and held that the rule applied but that more evidence was needed to show how much of the earnings and profits had actually passed to the new company.

> "Congress has determined that in certain types of transaction the economic changes are not definitive enough to be given tax consequences, and has clearly provided that gains and losses on such transactions shall not be recognized for income tax liability but shall be taken account of later. Sec. 112, 113. *It is sensible to carry through the theory in determining the tax effect of such transactions on earnings and profits.* Compare *Commissioner v. Sansome*, 60 F. (2d) 931. * * *" (Emphasis ours.)

The rule as thus stated by the Supreme Court, has been recognized many times in the last sixteen years by the Federal Courts and the Board of Tax Appeals. The following direct quotations are all from cases involving the application of the rule to tax-free corporate reorganizations or liquidations within the meaning of the Internal Revenue Code and applicable Revenue Acts:

United States v. Kauffman, (CCA-9th, Jan. 23, 1933) 62 F. 2d 1045, 1047:

> "In that case [Sansome] it was held that a reorganization of a corporation whereby the stockholders of an old company received stock of a new corporation in exchange therefor, wherein the stockholders were not taxable for a gain or loss under section 202(c)(2), *supra*, was not such a change in corporate identity as prevented the new company from being *considered as a continuing venture* under section 201 of the Revenue Act of 1921 (42 Stat. 228) and that whatever were earnings of the original corporation continued to be such in the hands of the new corporation." (Emphasis ours.)

Georday Enterprises, Ltd. v. Commissioner, (CCA-4, Mar. 9, 1942), 126 F. 2d 384, 389:

> "The meat of the Sansome case is found in a statement by Circuit Judge Learned Hand * * * 'Hence, we hold that a corporate reorganization which results in no "gain or loss" * * * does not toll the company's life as continued venture * * * and that what were "earnings or profits" of the original, or subsidiary, company remain, for purposes of distribution, "earnings or profits" of the successor, or parent, in liquidation.'"

Reed Drug Co. v. Commissioner, (CCA-6, Aug. 28, 1942), 130 F. 2d 288, 290:

> "Such corporate transactions * * * do not break the continuity of the corporate life."

Robinette v. Commissioner, (CCA-9, Mar. 19, 1945), 148 F. 2d 513, 516:

> "The earnings and profits of Cole-French Company, in existence when liquidation occurred, did not disappear. Either the subsidiary or the parent company had them. * * * The parent completely took over the subsidiary. There is *complete identity* of the corporations." (Emphasis ours.)

George F. Baker v. Commissioner, (CCA-2, Jan. 6, 1936), 80 F. 2d 813, 815, (affirming 28 B.T.A. 704):

> "It (parent company) had not in fact earned all of this amount itself, *but the combined taxable earnings of itself and of the five predecessor companies* made up that amount. As the taking over of those five companies by Consolidated was a nontaxable reorganization, their earnings had the same taxable status after the reorganization as before. They became the post February 28, 1913, earnings and profits of Consolidated so far as taxation is concerned. *Commissioner v. Sansome* (CCA), 60 F. (2d) 931." (Emphasis ours.)

Estate of Howard McClintic (June 25, 1942), 47 B.T.A. 188, 202:

> "The Sansome decision is predicated on the thought that a tax-free exchange does not operate to 'break the continuity of the corporate life,' and that therefore when a reorganization 'does not toll the company's life as continued venture' the earnings of the 'original, or subsidiary, company remain * * * "earnings or profits" of the successor, or parent.' This is because such reorganizations do not 'result in any "gain or loss" to the shareholder participating in them.'
>
> "Thus when the shareholders in McClintic-Marshall received stock of Union in lieu of a portion of what their McClintic-Marshall stock had theretofore represented there was a continuity of the corporate

life of the McClintic-Marshall-Union corporate enterprise."

In the instant case the dissolution of the five subsidiaries and the transfer of their assets to the parent corporation was a non-taxable transaction. Consequently the lives of the liquidated corporations were not "tolled" but continued as part of the life of the parent corporation with which they were consolidated. One of the results of this merger is that the earnings and profits accounts of the dissolved corporations become part of the earnings and profits account of the parent corporation, the taxpayer and respondent herein.

2. Under the continued venture principle of the Sansome case, the four subsidiaries having deficits in their earnings and profits accounts must be treated in the same manner as the one subsidiary having a surplus in its earnings and profits account.

The *Sansome* rule was thus interpreted in the case of *Harter v. Helvering*, 30 B.T.A. 572, (CCA-2, July 8, 1935), 79 F. 2d 12, in which Judge Learned Hand again rendered the decision for the same court that had considered the original *Sansome* case.

In the *Harter* case there were two separate reorganizations. The first reorganization was a merger of Philadelphia Paper Manufacturing Company and Fibre Container Company, each of which had a surplus in its earnings and profits account. The emerging corporation was named New Company. As to this merger, the opinion states (p. 13):

> "When the Philadelphia Paper Manufacturing Company and the Fibre Container Company merged on June 30, 1923, no gain was 'recognized' to the shareholders, for it was a 'reorganization' under section 202(c)(2) of the Revenue Act of 1924 (42 Stat. 229), and section 203(b)(2) of the Revenue Act of 1926, 26 USCA Sec. 934 (b)(2). A *consequence* of this is that for purposes of allocating dividends under section 201(b) of the Revenue Act of 1926, 26 USCA Sec. 932(b), against earnings before and after March 1, 1913, the surplus is regarded as unchanged. The Commissioner proceeded on the assumption that the shares issued by the New Company, $3,164,750, 'impounded' a corresponding amount of surplus and

> left for distribution as dividend only the bookkeeping surplus, $1,692,384.34. We have decided otherwise, Commissioner v. Sansome, 60 F. (2d) 931, and the Ninth Circuit agrees. U.S. v. Kauffman, 62 F. (2d) 1045. *Thus the surplus of the New Company was the difference between the assets of both the old companies and the capital shares of both, $4,307,134.34 . . .*" (Emphasis ours.)

The second reorganization involved in the case was a consolidation of New Company with Boxboard Company. New Company had a substantial surplus in its earnings and profits account but Boxboard had a deficit of $17,388.95. The Court held that upon the merger of New Company and Boxboard Company, the earnings and profits account of the emerging company, which was Boxboard, was not the surplus of New Company undiminished by the deficit of Boxboard Company, but was the contrary, i.e., the surplus of New Company reduced by the deficit of Boxboard Company. Referring to the last sentence in the above quotation from its opinion, the Court expressly pointed out the manner in which this result was reached (p. 13):

> "*Again when in April 1926, the New Company consolidated with the Boxboard Company, the same result ensued; for purposes of allocation the capital was $516,945, and the surplus, $4,289,745.39 . . .*" (Emphasis ours.)

Hence, in the *Harter* case the Court held, as to the first reorganization, that the surplus of the emerging new company was the difference between the assets of both the old companies and the capital shares of both. Then, as to the second reorganization, the Court expressly declared in applying the *Sansome* rule to a merger of a surplus company and a *deficit* company, *the same result ensued* as in the case of merger of surplus companies, to-wit: the successor or emerging company has assets consisting of the total of both companies' assets, and has a surplus or deficit in its earnings and profits account determined by subtracting the combined capital from the combined assets. As a result of this rule, each constituent company's earnings and profits account continues to exist in the corresponding ac-

count of the emerging company,—a surplus in the earnings and profits account is not converted into additional capital, nor is a deficit in the earnings and profits account eliminated by a reduction of capital.

The Court's computations are more easily visualized by the following table:

	Net Assets		Capital		Earnings & Profits
New Company (before merger)	$a	minus	$x	equals	$4,307,134.34 (surplus)
Boxboard Company (before merger)	$b	minus	$y	equals	—(17,388.95) (deficit)
One Company (Upon merger)	$(a+b)	minus	$(x+y)	equals	$4,289,745.39 (surplus)

Petitioner attempts to distinguish the *Harter* case as one involving the carrying forward of a surplus, saying there is not even dicta supporting the view that the deficit of the predecessor or subsidiary should enter into the computation of the earnings and profits account of the parent. On the contrary the case is direct authority for the proposition that a deficit must enter into the computation. The *method* of the computation expressly set forth by the same Judge who first enunciated the *Sansome* rule in the *Sansome* case *requires* that deficit companies and surplus companies be treated alike, and that existing surpluses and existing deficits be combined in the emerging company. By this method the balance, whether surplus or deficit, in the emerging company's earnings and profits account has to be the same, irrespective of which company emerges from the standpoint of corporation law.

The *Sansome* rule was applied to a company having a *deficit* in its earnings and profits account by the Commissioner and approved by the Tax Court in the case of *Senior Investment Company v. Commissioner* (Jan. 15, 1943) 2 T. C. 124.

In that case the taxpayer company organized a subsidiary corporation to which it transferred a portion of its assets in exchange for all of the stock of the subsidiary, i.e., a tax-free reorganization. The taxpayer company had a large deficit and in the reorganization a portion of this was allo-

cated to the subsidiary. After the transaction was completed, the question arose, under the Revenue Act of 1936 which assessed a tax on undistributed profits, as to whether the taxpayer company had a deficit in its earnings and profits account, the Commissioner's contention being that a greater amount of such deficit was allocable to the subsidiary. The Court said (p. 137):

> "It is the rule that, where the assets of one corporation pass to a successor corporation in a tax-free reorganization, the accumulated earnings and profits of the old corporation pass to the successor *with the same status* and are available for the payment of dividends by the latter, Commissioner v. Sansome, 60 Fed. (2d) 931; certiorari denied 287 U.S. 667; United States v. Kauffman, 68 Fed. (2d) 1045; Reed Drug Co. v. Commissioner, 130 Fed. (2d) 288; Helen V. Crocker, 29 B.T.A. 773; and that where only part of the assets are so transferred, it is proper to make an allocation of the earnings and profits between the two corporations in proportion to the assets transferred and the assets retained.
>
> "The Respondent (Commissioner) questions the Petitioner's claim that it is a deficit corporation; *but he makes no contention that the principles of the foregoing cases do not apply to the inheritance or absorption of a deficit.* * * *" (Emphasis ours.)

The Tax Court then held that whether the basis of allocation of the deficit accorded with the taxpayer's contention or the Commissioner's was immaterial since in either event a sufficient deficit would be retained by the taxpayer to give it the desired credit.

Although the statute and precise issue involved in the *Senior Investment Company* case, *supra*, are different from the statute and precise issue involved in the instant case and in the Sansome case, nonetheless the Tax Court has regarded the *Senior* case as being authority for application of the *Sansome* rule to an issue quite similar to the instant case.

In *Stella K. Mandel* (Sept. 10, 1945), 5 T. C. 684, involving a tax-free split-off reorganization in which it was conceded

that the *Sansome* rule applied, the issue was the proper allocation of surplus between old and new companies for the purpose of determining whether or not distributions of the new company were from accumulated earnings or profits and hence taxable as dividends. The statute involved in the *Mandel* case was the same as the statute involved in the instant case. In sustaining the Commissioner's method of allocating surplus to the successor company, the Tax Court relied upon the *Senior* case as follows (p. 688):

> "The Petitioner's theory of allocation raises a question which does not appear to have been heretofore specifically presented and settled in the decided cases, though inherent in a number of them. However, as a general proposition, the method of allocation urged by the respondent finds abundant support in decided cases. See *Barnes v. United States*, 22 Fed. Supp. 282; *Estate of Howard H. McClintic*, 47 BTA 188 (appealed CCA-3, settled by stipulation in compromise); *Senior Investment Corporation*, 2 T. C. 124. In the instant transaction it clearly appears that there is a substantial identity of the old company in the several corporations involved and that there is a continuity of proprietary interests so as to make the rationale of the above cases applicable."

And in the earlier case of *Crocker v. Commissioner* (Jan. 17, 1934), 29 B.T.A. 773, the Board said:

> "It is also true that it is merely stipulated that the surplus of the three was sufficient to pay the dividends so that *it may be that one of them had a deficit.* If so, petitioners have failed to this extent in their proof. *But we do not think that such a fact, if true, makes any difference.* If the successor corporation had a surplus inherited from all its predecessors sufficient to pay the dividends, it matters not in what proportions it was contributed." (Emphasis ours.)

In the course of this litigation Petitioner has cited but one case which he asserts supports his claim that earnings and profits accounts showing a deficit can not be combined under the *Sansome* rule: *Cranson v. United States* (CCA-2, Jan. 24, 1945) 146 F. 2d 874, certiorari denied, 326 U.S. 717.

In the *Cranson* case, a parent company (The Honolulu Oil Corporation, Ltd.) liquidated (tax free) three wholly owned subsidiaries on August 31, 1936, when the subsidiaries had substantial deficits.

The statute involved in the *Cranson* case was the same as in the instant case—the Revenue Act of 1936. Section 115(a)(b) of that Act[1] provides that corporate distributions shall be considered as paid first from the earnings of the current year, and then from earnings accumulated since February 28, 1913. To the extent that there are net earnings of the current year, the distribution is a taxable dividend, even though there are no accumulated earnings from prior years, or even if there is a deficit in prior years. In the instant case this was recognized and the taxpayer conceded (R. 11) and the Tax Court found as a fact (R. 14), that the distributions in the year 1937 were taxable to the extent of the earnings of that year. In the instant case the sole issue is the effect of the subsidiaries' deficits upon *accumulated* earnings and profits. In the *Cranson* case, however, the taxpayer insisted that the deficits of the subsidiaries should be applied to reduce not the *accumulated* earnings prior to 1936, but the *current* earnings of 1936.

The Court said (p. 871):

> "If Honolulu itself had at the beginning of 1936 the same operating deficit, the deficit could not have been deducted."

and later in the opinion (p. 872):

> "The equation of operating deficit for tax purposes is the loss sustained within the taxable year. As to the alternative contention of the appellant here that if the operating deficits do not diminish the earnings, the losses sustained in the liquidation would diminish earnings, there has been no showing that any of the loss was incurred in the tax year in question. Furthermore, it is apparent that appellant has not maintained its burden of proof that any of the deficits occurred in the tax year 1936. * * * It is hence

[1] Appendix, pp. 43-44.

not before us to consider whether any such deficits would be deductible from the profits of the parent corporation if they had occurred in the tax year 1936.

"Whether or not the parent company suffered losses in the tax years prior to 1936, if there be corporate earnings or profit in that year the Revenue Act of 1936 provides that distributions to the stockholders in that year are deemed to be from its most recently accumulated earnings or profits for that year, without regard to the fact that they are earned in that portion of the year after the distribution was made."

It is obvious, therefore, that the Court and the parties were addressing themselves to the question as to whether the deficits of the subsidiaries were deductible from *current earnings* of the parent for the year in which the distributions were made. That question is not involved in the instant case and was not passed upon by the Tenth Circuit Court of Appeals in its decision herein.[1]

Respondent therefore submits that the *Cranson* case is no authority for petitioner's argument in the instant case.

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[1]Petitioner states in his brief that the total dividend paid by the parent in 1936 amounted to $937,743, and argues that the distribution in 1936 exceeded the 1936 current earnings of $931,553.32 by $6,189.19, and that, as to the latter amount (i.e., 66/100 of 1% of the distribution), the distribution could have been held a dividend only if the parent's accumulated earnings prior to 1936 were not affected by the subsidiaries' deficits. On the basis of this 66/100 of 1% (which as to Mr. Cranson amounted to $2.97) petitioner argues that the court to that extent rendered a decision in conflict with the instant case. The figure of $937,743 as the amount of the dividend is not mentioned in the decision of the Circuit Court of Appeals in the *Cranson* case, and petitioner ascertains the amount by reference to the record in the case of *Lorin A. Cranson v. United States of America*, No. 85, October Term, 1944, of this Court, which is not part of the record of the instant case. Reference to the briefs in Case No. 85 discloses, however, that the entire argument was centered on the question of the right to deduct deficits of the subsidiaries for prior years from the *current* earnings of the parent company for 1936 and no reference was made to the question involved in the instant case. A second case by Cranson, covering distribution in 1938, (32 A.F.T.R. 1640) was, by stipulation of the parties, decided in accordance with the foregoing decision. *Lorin A. Cranson v. United States*, 151 F. 2d 1021.

In the instant case both the Tax Court and the Circuit Court of Appeals approved and applied the *Sansome* rule as applied to deficits in earnings and profits accounts.

The Tax Court held (R. p. 22):

> "After reviewing with care the above authorities we have come to the conclusion that the Sansome and Harter cases are controlling here. The primary principle announced in the Sansome case, and since consistently followed, was that a nontaxable reorganization does not toll the life of the constituent corporations as a continued venture, and it was only the result of that conclusion to add that earnings or profits of an original or subsidiary corporation remained earnings or profits of the successor, or parent, corporation. The venture continues regardless as to whether there had been surplus or deficit in the finances of the constituent corporation; therefore, in our view, the deficit is carried forward into the finances of the resultant corporation, equally with a surplus of any other constituent, and in both cases alike there is effect on the ability to distribute earnings and profits. The petitioner's corporation is merely a prolongation, in reorganized form, of a 'substantial identity' of financial situation and a 'continuity of proprietary interests,' to use the words of the *Mandel* case, *supra*. *No convincing reason appears to differentiate between surplus and deficit in the theory of continued venture.*" (Emphasis ours.)

The Circuit Court of Appeals held (majority opinion, R. pp. 31-32):

> "In a tax-free reorganization of corporations where a parent liquidates a wholly owned subsidiary, taking over its assets subject to their liabilities in complete cancellation and redemption of its issued and outstanding capital stock, or where two corporations merge, the entire corporate life survives as a continued venture insofar as tax consequences are concerned. A transaction of that kind does not produce any change in respect of tax purposes, the successor being merely the continuation of the predecessor. The principle is not a narrow one, limited to accumulated earnings or profits of the liquidated or absorbed company. It includes a deficit in the earnings or profits account of such company. The earn-

ings and profits accounts of the transferor company, whether consisting of credit balances or deficits, should be reflected in the corresponding accounts of the transferee company and should be taken into account in determining whether distributions subsequently made to stockholders of the emerged company were paid out of earnings or profits or out of capital."

The decisions of the Tax Court and the Circuit Court below correctly interpret and apply the *Sansome* rule in accord with Judge Hand's decisions in the *Sansome* and *Harter* cases. Those cases declared the broad principle that for the purpose of allocating assets between the tax concepts of capital and earnings and profits, the life of a predecessor or subsidiary company is not tolled but is continued in the successor or parent company. Those cases require that the earnings and profits accounts of all the companies, whether reflecting surplus or deficit balances, be combined in that account of the successor or parent. No case has held that deficit balances should not enter into the computation, and in the *Senior Investment Co.* case the Commissioner urged before the Tax Court that a greater amount of that taxpayer's deficit should be attributed to the transferee company.

3. Sound income tax accounting requires that the Sansome rule shall be construed to contemplate the consolidation of the earnings and profits accounts of the subsidiaries and the parent and Congress so intended.

The words "earnings and profits" refer merely to an account; the word "deficit" refers merely to a minus balance in that account; and the word "surplus" connotes simply a plus balance in such account.[1] Neither the capital account nor the earnings and profits account of a corporation stands for or represents any specific assets or any specific property.

[1] In the *Wheeler* case, *supra*, this Court commented on the meaning of the term "earnings and profits," and pointed out that both losses and gains enter into their computation. It follows that losses may exceed gains and the "earnings and profits" account may show a deficit. The *Harter* case, and the *Senior* case, *supra*, both applying the "Sansome" rule, show that the term "earnings and profits" refers to an account by that name which may or may not have a credit balance or surplus.

The capital account reflects that portion of a company's total assets which is represented by the funds paid in by contributing stockholders as "capital." For tax purposes a corporation's capital as reflected by its capital account remains constant (except as it is increased by contributions from, or decreased by distributions to, its stockholders). The gains or losses of the corporation do not increase or decrease "capital."

The earnings and profits account reflects the difference between the corporation's net assets (i.e. assets minus liabilities) and its capital, and is therefore the balancing figures in an equation.[1]

The equation is: net assets (i.e. assets reduced by liabilities) equals capital plus earnings and profits. A company's net assets must always be exactly equal to its capital plus its earnings and profits.

A corporation which has sustained operating losses sufficiently great so that its net assets are less than its capital, thus has a deficit in earnings and profits. Such a corporation does not have any accumulated earnings and profits out of which dividends can be paid until it realizes sufficient earnings to restore such deficit.[2]

[1] Fletcher, Cyclopedia of Corporations, Vol. 11, Sec. 5335: "It may be laid down as a general proposition . . . that the surplus or net profits of a corporation are the difference between the total present value of its assets, after deducting losses and liabilities, and the amount of its capital stock." The earnings and profits account represents "a balance sheet position." Note on instant case in Harvard Law Review, May 1947, p. 826.

[2] "MEANING OF 'ACCUMULATED EARNINGS OR PROFITS.' The statute includes in the term 'dividend' not only distributions out of current earnings or profits, but also distributions out of 'accumulated' earnings or profits (since February 28, 1913). Accordingly, prior to the 1936 Act, any distribution, and since the 1936 Act, the excess of distribution over current earnings, is a taxable dividend only if there exist earnings or profits accumulated after February 28, 1913. *An impairment of fixed or statutory capital occasioned by a deficit must be restored out of subsequent earnings before there can be accumulated earnings or profits available for dividends. The same rule governs impairments of capital surplus or paid-in surplus.*" (Emphasis ours.) Mertens, Law of Federal Income Taxation, Vol 1, Sec. 9.30, p. 461.

If the *Sansome* rule applies to surpluses only it penalizes the corporate group because it does not permit deficits in the earnings and profits accounts of the merging companies to be restored out of the combined earnings of those companies. This illogical result can be readily shown.

Suppose, for example, that a single individual has organized two corporations, contributing $100,000 in cash to each for all of the stock of each company. Suppose, further, that in a given period one corporation earns and retains profits amounting to $25,000, while the other sustains operating losses of $25,000. At this point the one corporation would have a surplus in its earnings and profits account of $25,000, its assets having been increased by profitable operations in that amount; while the other corporation through losses would have reduced its assets by $25,000 and would have a corresponding deficit in its earnings and profits account. The results of these operations for each corporation shown in abbreviated balance sheet form, would be as follows:

	Company A	Company B
Net Assets (i.e. Assets minus Liabilities)	$125,000	$ 75,000
Capital	100,000	100,000
Earnings and Profits—		
Surplus or (Deficit)	25,000	(25,000)
Total—capital and earnings	$125,000	$ 75,000

Suppose, then, these two corporations were merged. Petitioner admits that under the *Harter* case, if B is the company emerging from such a consolidation, then it would be proper to carry forward the surplus in earnings and profits of A into the computation of the earnings and profits account of the new company B. Thus, the earnings and profits account of the two companies after consolidation into B would be zero, since the surplus of A of $25,000 would be carried over to B and would offset B's deficit of $25,000. But Petitioner, attempting to distinguish *Harter*, contends that if A is the company which emerges, then the combined earnings and profits account of these same two companies would not be zero, but would be a *surplus* in earnings and

profits of $25,000. Petitioner argues that although the surplus of A can be combined with B's deficit, yet the deficit of B cannot be combined with A's surplus in computing the earnings and profits of the combined company. Obviously it is of no significance whether A is merged into B or B is merged into A. Whichever company emerges will own the same assets, A's assets plus B's assets, totaling in the example $200,000; and irrespective of which company emerges, the fact remains that the stockholder has a capital investment of $200,000 in the emerging company. Since the combined assets total $200,000 and the combined capital totals $200,000, all the assets represent capital and none represent earnings. Clearly the result is the same whether A or B emerges from the consolidation.

Congress has, over the years, gradually evolved a plan of *tax* accounting to be applied to liquidations under Sec. 112(b)(6)[1] as well as to other rearrangements of corporate relationships where the identity of the business and economic interest continues but under a different form. The rules applicable in 1936, when the transactions here involved occurred, included the following:

1. The loss or gain of the parent on receipt by the parent of the assets of the subsidiary is not recognized for tax purposes at the time of liquidation. (Sec. 112(b)(6).)[2]

2. The assets so received must be entered on the parent's books at the cost shown on the subsidiary's books at the date of liquidation. (Sec. 113(a)(15).)[3]

3. When the assets are subsequently sold gain or loss is then recognized in the amount of the difference between the sale price and the subsidiary's cost and the gain or loss so recognized is then for the first time reflected in the earnings and profits account of the parent. (Sec. 115(l) added by Sec. 501 of the Second Revenue Act of 1940 and made retroactive.)[4]

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[1] Appendix, p. 43.
[2] Appendix, p. 43.
[3] Appendix, p. 43.
[4] Appendix, p. 45.

4. The distribution of assets to the parent on liquidation is not considered a distribution of earnings and profits of any corporation. (Sec. 115(h).)[1]

5. The earnings and profits account of the subsidiary are transferred to the parent and become part of the parent's earnings and profits account. (*Sansome* rule, a rule of judicial construction recognized by Congress.)

The following examples will clearly show that the *Sansome* rule and Sections 112(b)(6), 115(l) and 113(a)(15), are integral parts of the plan of Congress and that without the *Sansome* rule the provisions of the statute produce an illogical and unjust effect. In all of these examples the values and figures used represent sound income-tax accounting figures.

A. We will first consider the case where none of the corporations has had an operating loss and the facts are as follows:

(1) P. Co., the parent, contributed $100,000 as capital for all the stock of each of three companies, A, B and C.

(2) A. Co. realized neither profits nor losses through operations.

(3) B. Co. realized profits of $200,000 through operations.

(4) C. Co. realized profits of $400,000 through operations.

(5) At time of liquidation the fair market value of the assets of each company was $500,000.

Balance sheets of the subsidiaries immediately prior to liquidation will thus be as follows, it being noted that the unrealized appreciation of the assets of companies A and B is not, for income tax purposes, reflected thereon:

[1] Appendix, p. 44.

A. Co.

Assets	$100,000	Capital	$100,000
		Earnings and Profits	
	$100,000		$100,000

Applying the tax accounting rule above stated to the liquidation of A. Co.:

The increase in book value of A's assets from $100,000 to $500,000 is due to appreciation of asset values and not to earnings and profits.

P receives assets worth $500,000 for stock which cost it $100,000, but the gain of $400,000 is not recognized.

P sets up the assets received at $100,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by the receipt of assets worth $500,000 because the gain is not recognized and there are no earnings and profits in A's accounts to be transferred to P.

No occasion to apply *Sansome* rule.

B. Co.

Assets	$300,000	Capital	$100,000
		Earnings and Profits	200,000
	$300,000		$300,000

The increase in book value of B's assets from $100,000 to $300,000 is due to earnings and profits. The difference between the book value of $300,000 and $500,000 market value is due to appreciation of asset values.

P receives assets of $500,000 for stock which cost it $100,000, but the gain of $400,000 is not recognized.

P sets up the assets received at $300,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not charged by its receipt of assets worth $500,000 but it will be increased by so much of that amount as represents the earnings and profits of B, namely, $200,000, according to the *Sansome* rule.

C Co.

Assets	$500,000	Capital	$100,000
		Earnings and Profits	400,000
	$500,000		$500,000

The increase in book value of C's assets from $100,000 to $500,000 is due to earnings and profits alone.

P receives assets of $500,000 for stock which cost it $100,000, but the gain of $400,000 is not recognized.

P sets up the assets received at $500,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $500,000 but it will be increased by so much of that amount as represents the earnings and profits of C, namely, $400,000, according to the *Sansome* rule.

It will be thus seen that where the subsidiaries have not been operated at a loss prior to their liquidation, the correct effect upon P Co.'s earnings and profits account is obtained in all cases either by the operation of the applicable sections of the statute, or by the operation of such sections in conjunction with the *Sansome* rule, or by the operation of the *Sansome* rule alone.

B. We will next consider the case where two of the corporations have operated at a loss and the facts are as follows.

(1) P Co., the parent, contributed $500,000 as capital for all of the stock of each of three companies, X, Y and Z.

(2) X Co. realized neither profits nor losses through operations.

(3) Y Co. realized losses of $200,000 through operations.

(4) Z Co. realized losses of $400,000 through operations.

(5) At time of liquidation the fair market value of the assets of each company was $100,000.

Balance sheets of the subsidiaries immediately prior to liquidation will thus be as follows, it being noted that the unrealized depreciation of the assets of companies X and Y is not, for income tax purposes, reflected thereon:

		X Co.	
Assets	$500,000	Capital	$500,000
		Earnings and Profits	
	$500,000		$500,000

The decrease in book value of X's assets from $500,000 to $100,000 is due to depreciation in asset values and not to operating losses.

P receives assets worth $100,000 for stock which cost it $500,000, but the loss of $400,000 is not recognized.

P sets up the assets received at $500,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $100,000 because its loss is not recognized and there are no earnings or profits in X's accounts to be transferred to P.

No occasion to apply *Sansome* rule.

		Y Co.	
Assets	$300,000	Capital	$500,000
		Earnings and Profits (deficit)	(200,000)
	$300,000		$300,000

The decrease in book value of Y's assets from $500,000 to $100,000 is due to loss of asset value caused by the operating loss (deficit in earnings and profits) to the extent of $200,000, and to shrinkage in asset value to the extent of $200,000.

P receives assets worth $100,000 for stock which cost it $500,000, but the loss of $400,000 is not recognized.

P sets up the assets received at $300,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $100,000 because the loss is not recognized, but its account should be charged with the deficit in the earnings and profits account of Y because otherwise the loss of asset value when the operating expenses of Y consumed $200,000 of assets can never be recouped. It is only by the application of the *Sansome* rule that this inequity can be corrected.

		Z Co.	
Assets	$100,000	Capital	$500,000
		Earnings and Profits (Deficit)	(400,000)
	$100,000		$100,000

The decrease in value of Z's assets from $500,000 to $100,000 is due entirely to operating losses (deficit in earnings and profits).

P receives assets worth $100,000 for stock which cost it $500,000, but the loss of $400,000 is not recognized.

P sets up the assets received at $100,000 and will have a recognized loss or gain whenever it sells the assets, and this loss or gain will then be reflected in P's earnings and profits account.

P's earnings and profits account is not changed by its receipt of assets worth $100,000 because the loss is not recognized, but its earnings and profits account should be

charged with the deficit in the earnings and profits account of Z because otherwise the loss of asset value when the operating expenses of Z consumed $400,000 of assets can never be recouped. It is only by the application of the *Sansome* rule that this inequity can be corrected.

Failure to apply the *Sansome* rule to subsidiaries having deficits would not only grossly distort the earnings and profits account of the parent but would also produce a corresponding reduction of capital. This can be very simply demonstrated by reference to the foregoing examples. Assume that P. Co., the parent, was organized with $600,000 paid in for its capital stock, and that P. Co. thereupon organized the two above subsidiaries C and Z, paying in $100,000 and $500,000 respectively for the subsidiaries' capital stock. As in the above examples, when the two subsidiaries are liquidated C has a surplus in its earnings and profits account of $400,000 and Z has a deficit in its earnings and profits account of $400,000. The balance sheets of the parent and its two subsidiaries just prior to the liquidations are as follows:

P. Co.

Assets:		Capital	$600,000
Stock of C. Co. (*a* Cost)	$100,000	Earnings and Profits	-0-
Stock of Z Co. (*a* Cost)	500,000		
	$600,000		$600,000

C. Co.

Assets	$500,000	Capital	$100,000
		Earnings and Profits Surplus	400,000
	$500,000		$500,000

Z. Co.

Assets	$100,000	Capital	$500,000
		Earnings and Profits (deficit)	400,000
	$100,000		$100,000

If the *Sansome* rule is applied to C. Co. but not to Z. Co., then the financial structure of P. Co. for tax purposes after the liquidations would be reflected upon a balance sheet as follows:

Assets:		Capital	$200,000
Property of C Co. (@ C's basis)	$500,000	Earnings and Profits (surplus)	400,000
Property of Z Co. (@ Z's basis)	100,000		
	$600,000		$600,000

If the *Sansome* rule does not apply to Z. Co., then upon the liquidations Z's deficit of $400,000 is wiped out and C's surplus of $400,000 is attributed to the parent. In such event the parent's capital must be reduced since the total of the capital account and the earnings and profits account must always exactly equal the total assets. In the example, P's assets after liquidation amount to $600,000. If those assets represent earnings and profits to the extent of $400,000, then only the balance of $200,000 is left to be allocated to capital. Before the liquidations, P. Co. owned $600,000 of assets (stock of C and Z) which exactly equaled the capital with which it started business and which was paid in as capital by its stockholders, none of which represented earnings. After such liquidations P. Co. owns $600,000 of assets (property of C and Z) which exactly equals the capital with which it started business all of which should still represent capital and none of which should represent earnings. But if the *Sansome* rule does not apply to the deficit subsidiary, such $600,000 of assets represent earnings of $400,000 and capital only to the extent of $200,000.[1]

If the *Sansome* rule does apply to both C and Z, then the balance sheet of P. Co. for tax purposes after the liquidations would be:

[1] Such an application of the rule would thus tax as income a distribution of the corporation's capital—a result never intended by Congress.

Assets:		Capital	$600,000
Property of C Co. (at C's basis)	$500,000	Earnings and Profits	none
Property of Z Co. (at Z's basis)	100,000		
	$600,000		$600,000

This would reflect the true economic status of the enterprise.

From the foregoing study of the possible situations which may arise both where corporations are operated at a profit and where they are operated at a loss, we submit that it is evident that the only way in which all situations can be treated equitably is by the application of the *Sansome* rule to both surpluses and deficits in earnings and profits accounts.

Congress has said to the parent company:

(1) If you liquidate a wholly-owned subsidiary, you cannot take for income tax purposes your actual loss on that liquidation, nor do you have to report your actual gain.

(2) You must adopt as a basis for loss or gain the cost basis of the assets as shown on the books of the subsidiary, and if and when you sell any of these assets in the future, you must compute your loss or gain for income tax purposes as the difference between what you receive and this substituted basis.

The effect of these provisions is to place the assets after they have been received by the parent, in exactly the same status as they were in the hands of the subsidiary. There is a complete continuity of asset treatment. The losses and gains on disposition will be the same as though the liquidation had not taken place except that they will be the losses and gains of the parent and not of the subsidiary.

In the *Sansome* and *Hunter* cases, Judge Hand saw the effect of this rule as to non-recognition of loss or gain determined by reference to the transferor's basis, realized that it was based on the theory of continuity of enterprise

and economic interest, and he pointed out that the theory must imply a complete continuity and that to accomplish that the earnings and profits account would have to be carried over in the same condition as it appeared on the books of the subsidiary.

This is what Congress believed when the Senate Finance Committee said, with respect to Sec. 50 of the Second Revenue Act of 1940 providing that unrecognized losses or gains should not decrease or increase earnings and profits, that this provision "is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee."[1]

Congress was then amending the statute as to the effect of unrecognized *gains or losses;* the *Sansome* rule had already taken care of surpluses and deficits in earnings and profits accounts and Congress had already approved it. It was bringing into line the handling of losses and gains.

Nowhere in any of the committee reports is there any statement or suggestion that Congress did not think the *Sansome* rule related to both surpluses and deficits in earnings and profits accounts. If it had thought differently, it is incredible that it should not have so stated by express legislation long ago.

The petitioner is confused because he is constantly trying to relate the reasons for or against the *Sansome* rule to alleged attempts to realize the actual losses or gains of the parent company. An examination of the laws and regulations as indicated above clearly shows that when the parent liquidates a wholly-owned corporation, it sacrifices forever any right to compute its loss or gain with reference to its actual cost of the stock of the subsidiary. It takes the subsidiary's base and position and goes on from there. The parent's cost may have been $100,000 for the stock; the assets received may have a fair market value of $500,000, but if the subsidiary's book value for those assets is $200,000,

[1] Sen. Rept. No. 2114, 76th Cong. 3d Sess., quoted at length *infra*, pp. 36-7.

then the parent's basis is $200,000 and that ends the discussion. The actual loss or gain of the parent has no place in this argument.[1]

It follows therefore that any argument on the question of the carrying forward of the earnings and profits account which attempts to relate the reasons for or against such carrying forward, to an attempt to realize losses or gains actually realized by the parent is unsound. It is not to "save something out of the wreck" that the parent has a right to carry forward a deficit in earnings and surplus. It is because it is the only process by which the financial picture can be preserved on the subsidiary's basis which is essential to the continuity of the corporate life, and ensure not merely the right to recoup operating losses as the subsidiary would have had the right to do, but the right of the government to tax distributions of funds that would have been taxable if distributed by the subsidiary. Neither one nor the other is the sole object or purpose of the *Sansome* rule. That rule is a "two-way" street, not a cul-de-sac as to deficits, and a wide-open highway as to surpluses.[2]

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[1]Similarly, the question of the loss or gain (if any) of a stockholder because of changes in the market value of his stock as the result of the liquidation has no bearing on the question here discussed.

[2]Robert H. Montgomery, well-known authority on federal tax questions, in his "*Federal Tax Handbook*," for 1940-41, referring to the *Sansome* and subsequent cases applying that rule, says (p. 317): "It would seem that the reasoning in the cases just cited would apply with equal force to the continuation in the successor corporation of the operating deficit of the predecessor corporation." And again at p. 472: "When a reorganization has taken place and no gain or loss has been recognized under the Code and prior Acts containing similar reorganization provisions, the bases of the old corporation must be used as the bases of the new corporation for determining gain or loss. . . . It is true that these provisions refer to computations of gain or loss arising from sales, but it would appear that the same rule should apply in computing profits from operations. In consonance with the spirit of the reorganization sections, if deferred credits are to be carried over as liabilities and reported as taxable income, by the same token, deferred debits of all kinds should be carried over as assets and reported as expenses by the new entity. The reasoning of the Circuit Court of Appeals, in the case of Commissioner v. Sansome . . . agrees with the author's construction of the reorganization provisions."

It has been claimed that to allow the deficits to be deducted from the parent's earnings and profits would be to allow a double deduction of these operating losses, once against consolidated income, and once against combined accumulated surpluses.* This would not be a double deduction but would be an adjustment in accord with customary income tax accounting.

Suppose, for example, an enterprise operated as a single corporation carrying on its business in five departments. Four operate at a loss, one at a profit. The operating losses of the four would be deductible for computing the income of the enterprise subject to tax and would also be deducted from the accumulated earnings and profits of the entire enterprise.

Suppose that each of the five departments was a separate wholly owned subsidiary of a parent corporation, and the six corporations together carried on the same enterprise. Under the income tax law permitting consolidated returns, the operating losses of the four unsuccessful corporations would be deducted from the combined income of the enterprise, but the deductions from earnings and profits accounts would be made against the separate earnings and profits accounts of the individual corporations; and it would only be upon liquidation accompanied by the deduction of the deficits from the combined earnings and profits of the enterprise that the true status of the enterprise as a whole would be correctly shown, and shown as it would have been if the enterprise had been operated as a single corporation with several departments instead of in several corporate entities. Since the *Sansome* rule contemplates the continuity of the enterprise it must contemplate the ultimate consolidation of the earnings and profits accounts, whether they show deficits or surpluses.

Furthermore, not to do so is inconsistent with the practice when surpluses exist. Suppose that the four unsuccessful

*The parent and five subsidiaries here involved filed consolidated returns for the years 1918 to 1933 inclusive, but the earnings or losses of the five subsidiaries were not reflected in the parent's surplus prior to Dec. 1, 1936. (R. p. 13.)

subsidiaries operated over several years at a loss after having had a period of successful operations, so that when they were liquidated after the several years of losses, their respective earnings and profits accounts still showed small surpluses. Under the *Sansome* rule these surpluses clearly become surpluses of the parent. During the loss years, however, the operating losses had been taken on the combined income tax return, and also deducted from the several earnings and profits accounts. If the argument based on its claim of double deduction is correct, the losses deducted from the combined income should not be permitted to reduce the combined surpluses after the liquidation. And yet the *Sansome* rule admittedly goes that far.

If it is proper to combine earnings and profits accounts whose balances are the remainders after substantial losses, why is it improper to combine such accounts when some or all of them actually show deficits? It is only a question of degree.

We therefore submit, that from the point of view of sound income tax accounting principles, it is essential that the *Sansome* rule be applied to the earnings and profits accounts of all the liquidated subsidiaries whether they show surpluses or deficits.

4. Congress has accepted and applied the Sansome rule with respect to both surpluses and deficits in earnings and profits accounts.

As this court declared in the *Munter* case, *supra*, the rule of the *Sansome* case, "which for tax purposes treats a reorganized corporation as being a continuation of its predecessors," has repeatedly received Congressional approval as a correct interpretation of the purpose of the tax laws governing reorganizations. The approval so accorded the *Sansome* rule by Congress occurred subsequent to the decision of the *Harter* case, *supra*, which case, as hereinbefore noted, involved application of the *Sansome* rule to a deficit company. The various committee reports hereinafter referred to nowhere indicate any Congressional intention that the *Sansome* rule should apply only to continue the life of a corporation having a surplus, but that the life of a deficit company should not be continued. If Congress intended

that the *Sansome* rule should not consist of the broad principle that the life of a reorganized corporation should be continued in its successor for tax purposes, but on the contrary that the *Sansome* rule should be confined to the narrow rule that a surplus should be carried over to a successor company, then such Congressional intent to so drastically restrict the application of the *Sansome* rule would have been a proper subject for specific legislation. At the least, such an intent would have appeared in Congressional committee reports. No intent to so limit the *Sansome* rule appears. On the contrary, the committee reports, in reference to the statutory provisions relating to the computation of equity invested capital for excess profits tax purposes, made in connection with the 1940 and 1942 Revenue Acts, expressly recognize the propriety of applying the *Sansome* rule to corporations having deficits.

The *Sansome* rule developed originally in connection with tax-free reorganizations. The *Sansome* case was decided on July 26, 1932, and the *Harter* case on July 8, 1935. It was not until January 1, 1936, the effective date of the Revenue Act of 1936, that the liquidation of a wholly owned subsidiary corporation was made tax free. (Sec. 112(b)(6) of the Revenue Act of 1936.)[1] The forerunner of this provision was an amendment to the then pending bill entitled "Revenue Act of 1935" which was introduced by Senator Harrison on August 15, 1935, and which was subsequently enacted as a part of the 1935 Act.[2] Such provision did not, however, become effective since it was superseded by the Revenue Act of 1936.

The reasons for introducing this section were presented by Senator Harrison as to the 1935 Act, and by Senator George as to the 1936 Act, in the following language. The former said (Congressional Record, Vol. 79, p. 13239):

> "I have an amendment to submit that is not a committee amendment, but I have had the clerks work out something with reference to the policy to be ap-

[1] Appendix, p. 43.

[2] 49 Stats. 1014, 1020.

plied to holding companies in case of forced liquidation; and the experts think the amendment I am about to offer is the best that can be drafted."

The next year Senator George referred to the action of Congress in the prior year as follows (Congressional Record, Vol. 80, p. 8799):

> "Section 112(b)(6) of the present law was adopted last year by the Senate, as an amendment to the revenue bill of 1935. It was intended to permit the simplification of our corporate structures, and the liquidation of subsidiaries. * * * The present law requires a new 'basis' for the property of the subsidiary after the property has been taken over by the parent corporation. The protection of the Treasury, as well as sound policy, requires that the property retain the same basis after the liquidation as before."

The matter was again commented upon in Congress in connection with further amendments to this section in the Revenue Act of 1938, concerning which the report of the Senate Finance Committee contained the following statement (Senate Report No. 1567, 75th Congress, Third Session, page 7):[1]

> "The testimony presented to the committee in its hearings reveals that many corporate structures are excessively complicated, that the assets of many personal holding companies and foreign personal holding companies are frozen, and that the utility companies are faced with a death sentence and in addition, with a heavy tax penalty for carrying out the orders of the Federal Government."[2]

In connection with the introduction of this new provision for a tax-free liquidation of a wholly owned subsidiary, and subsequent changes in other provisions of the law relating to the basis of property distributed and the effect of such

[1] Published in Cumulative Bulletin, 1939-1 (Pt. 2), pp. 779, 783.

[2] When Senator Harrison introduced his amendment to the Revenue Act of 1935, on August 15, 1935, there was then pending a bill which was approved on August 26, 1935, and thereupon became law, entitled "Public Utility Holding Company Act of 1935" (15 U.S.C. Ch. 2C). It provided for registration and supervision of holding companies unless exempted by the Securities and Exchange Commission under the conditions set forth in the Act.

liquidations on earnings and profits, Congress apparently took for granted the application of the *Sansome* rule to such transactions. With reference to an amendment to Section 115(h) of the Revenue Act of 1936, relating to the effect of any non-taxable transactions on earnings and profits, the report of the Senate Finance Committee (Senate Report No. 2156, 74th Congress, 2nd Session, page 19)[1] stated:

> "The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a non-taxable stock dividend or a distribution of stock or securities in connection with a reorganization or other exchange, on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. This rule is stated only in part in section 115(h) of the Revenue Act of 1934, and corresponding provisions of prior Acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner v. Sansome* (60 Fed. (2d) 931); *United States v. Kauffman*, 62 Fed. (2d), 1045); *Marcheson v. Comm.* (76 Fed. (2d) 641). While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity."

This is the first Congressional statement of the *Sansome* rule and the Committee referred to the leading cases in three Circuit Courts of Appeal where the rule had already been recognized, obviously without endeavoring to cite all cases, including the case of *Hazlet vs. Helvering*, 79 Fed. (2d) 12, decided on July 8, 1935, in the same Circuit as the *Sansome* case.

In connection with another amendment of section 115(h) by the Revenue Act of 1938, expressly providing that a distribution of "property or money" in a non-taxable trans-

[1] Published in Cumulative Bulletin, 1939-1, pp. 678, 690.

action should not constitute a distribution of earnings or profits, the Senate Finance Committee, in its report, again stated that "the earnings or profits of the transferor corporation become in whole or in part the earnings or profits of such other corporation," referring to the *Sansome* rule as existing law and pointing out that the amendment was made in the interest of added clarity.[1]

Again, when considering the Second Revenue Act of 1940,[2] the House Committee on Ways and Means, in discussing the amendment inserting a new subsection (1) in Section 115 for the purpose of further clarifying the law with respect to what constitutes earnings and profits, as an aid to determining whether distributions are taxable dividends and also determining equity invested capital for excess profits tax purposes, said:[3]

> **"The rule, applied by the Treasury, under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115(h) of the Internal Revenue Code, and the principles established in *Commissioner v. Sansome* (60 Fed. (2d) 931) and following decisions, the rule effectuates the provisions of section 112."**

The Senate Finance Committee in its report on the same bill expressed the same thought:[4]

> "Under various provisions of the Internal Revenue Code dealing with the exchanges and *liquidations*, the transfer of the property by a corporation to another corporation results in the non-recognition,

[1] Sen. Rept. No. 4567, 75th Cong. 3rd Sess. p. 18 (published in Cumulative Bulletin, 1939-1 (Pt. 2) pp. 779, 792).

[2] Appendix, p. 45.

[3] H. R. Rept. No. 2894, 76th Cong. 3d Sess. p. 41 (published in Cumulative Bulletin, 1940-2, pp. 496, 526).

[4] Sen. Rept. No. 2114, 76th Cong. 3d Sess. p. 25 (published in Cumulative Bulletin, 1940-2, pp. 528, 546).

in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. *These principles are to be given full effect under section 501.* The requirement of section 501 that there shall be no increase *or decrease* in earnings and profits by reason of a wholly unrecognized gain *or loss is but another aspect* of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee." (Emphasis ours.)

In the Second Revenue Act of 1940 (54 Stats. 974, 975) Congress enacted an excess profits tax law. Petitioner argues that the provisions of this law as explained by the reports of the Congressional committees show that Congress interpreted the *Sansome* rule to apply only to surpluses in earnings and profits accounts. With this the respondent emphatically disagrees.

That act levied a tax on excess profits of corporations. One of the provisions granted an exemption from the tax on so much of a corporation's income as equalled a stated percentage of its invested capital. "Invested capital" was then defined in the statute by itemizing the elements which should be included or excluded, in computing such capital.

One of the items included was the following:

> "The accumulated earnings and profits as of the beginning of such taxable year" (Sec. 718(a)(4)).

One of the items excluded was the following:

> "The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits by reason of a transaction described in Section 112(b) to (e), both inclusive," etc. (Sec. 718(b)(3)).

Since the greater the invested capital the greater the credit, it was to the interest of the government to make the included items as small as possible and the excluded items as large as possible.

If, in the case of the liquidation of a subsidiary, as in our case, the deficit in its earnings and profits account passes under the *Sansome* rule to the parent and becomes part of its accumulated earnings and profits, then the invested capital of the parent corporation is reduced, the excess profits credit is reduced, and the excess profits tax is *increased*.

The report of the House Committee on Ways and Means on this point says (H.R. Rept. No. 2894, 76th Cong. 3rd Sess. pp. 25, 10 (Cumulative Bulletin, 1940-42, p. 496, at pp. 514, 503)):

> "If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account and in such cases the earnings and profits as of the beginning of the taxable year shall be considered as zero, for the purpose of computing the invested capital for such year."
>
> "Deficits in the earnings and profits account, moreover, do not reduce the invested capital. Nevertheless, deficits in the earnings and profits accounts must be made good out of earnings and profits before any increase in invested capital results from the earnings and profits account."

It is obvious that Congress did not intend to have deficits in earnings and profits accounts enter into the computation of invested capital until capital was completely restored out of future earnings and profits.

If, on the other hand, the liquidation of a subsidiary resulted in transferring to the parent a surplus in the earnings and profits account, the invested capital of the parent would be built up by that transfer. To prevent this Congress enacted the second provision of the statute above quoted. The forerunner of this section was 718(a)(4) of the House bill with regard to which the same committee report says (p. 25 Cumulative Bulletin, p. 514):

> "In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and

> shall be considered to be earnings and profits of the transferee for tax purposes. Subsection (c) (4) of Section 718 provides that such transferred earnings and profits shall *not* be taken into account in computing the earnings and profits as of the beginning of the taxable year for the purpose of determining the equity invested capital. Inasmuch as the property received by the transferee upon such a transfer is included in such cases in the equity invested capital at its adjusted basis in the hands of the transferor, *it is necessary to exclude* the earnings and profits acquired by the transferee by reason of such transfer *in order to avoid duplication.*" (Emphasis ours.)

And the report of the Conference Committee on the same bill (H.R. Rept. No. 3002, 76th Cong. 3rd Sess., p. 49 (Cumulative Bulletin, 1940-2, pp. 548, 555)) sums up both aspects of the situation:

> "The conference agreement also makes further technical changes in order to eliminate duplications in the computation of equity invested capital. Provisions have been inserted governing the extent to which the equity invested capital of a parent corporation is to be *increased or decreased* following a liquidation under section 112(b)(6). This provision enables the provisions of Section 718(b)(3) to be expanded *so as to cover all situations* in which, under the doctrine of *Commissioner v. Sansome*, (60 Fed. (2d), 931), the earnings and profits of one corporation become the earnings and profits of another." (Emphasis ours.)

The purpose of the foregoing provisions of the statute as explained by the committee reports seems to have been to strictly limit the invested capital of every corporation. To do this it was necessary to have the deficits of all merging corporations appear on the balance sheet of the emerging or parent corporation where they would either reduce the parent's earnings and profits, or not be considered at all if the overall figure was a deficit, until the deficit had been restored from earnings and profits. In the meantime they were valued at zero. On the other hand, all surpluses of earnings and profits accounts so received were required to

be eliminated from the computation of invested capital to "avoid duplication." Why then did Congress make special provision only for the elimination of the surpluses? Obviously because it was unnecessary to make a special provision for deficits. Under the *Sansome* rule the deficits automatically passed to the parent or emerging company, as did the surpluses. But it was necessary to insert a special provision to *take out* the surpluses to avoid duplication, because the assets received included the surpluses and were already entered in the computation of invested capital as property received and owned.

The respondent contends, therefore, that the entire Congressional history as revealed by the reports which we have quoted in this section of our brief, clearly show that Congress was fully cognizant of the *Sansome* rule as laid down in the *Sansome*, *Harter*, and subsequent cases, and has approved and applied the rule as construed by respondent herein.[1]

5. The application of the Sansome rule to deficit cases would not lead to tax avoidance or evasion.

Both this Court and Congress have provided rules which will prevent the use of the *Sansome* rule as interpreted in this brief to avoid or evade income taxes. This Court has in other cases involving tax-free changes in corporate relationships required a business purpose and when that requirement is applied to a transaction such as we have in this case, the rule would naturally be governed by such cases as—

Gregory v. Helvering, 293 U.S. 465
Bazley v. Commissioner, 331 U.S. 737
Helvering v. Elkhorn Coal Co. (CCA 4)
95 Fed. (2d) 732, certiorari denied,
305 U.S. 605, 670.

[1] The amendments to the Excess Profits Tax Law made by the Revenue Act of 1942 (56 Stats. 798, 932) entirely changed the theory of determining invested capital in the case of liquidations under Section 112(b)(6) and are not in point.

Section 45 of the Internal Revenue Code gives the Commissioner broad powers to control manipulations of corporate relationships, and in the case of corporations making consolidated returns Section 141 makes special provision for such situations which supplement the provisions of Section 45.[1]

Congress also added Sec. 129[2] to the Internal Revenue Code expressly covering acquisitions of control of corporations or the assets of other corporations with the "principal purpose" of "evasion and avoidance of federal income or excess profits taxes," and providing that deductions arising from such acquisitions should be disallowed.

In the instant case, there is no suggestion that the motive for liquidation was to avoid taxes, or that the subsidiary companies were acquired for that purpose, or that there was anything except a sound business purpose for the liquidation of the five subsidiaries.

CONCLUSION

The underlying principle of the law as stated in Section 112(b)(6) of the Revenue Act of 1936 interpreted by the application of the *Sansome* rule, is therefore, that where a business is a unit, although organized in the form of a group of corporations, the inter-company liquidations shall not be allowed to distort the real financial interests and the economic results of the enterprise. This was the underlying principle behind the "reorganization" provisions of the law from the beginning, and it has since been neither changed nor limited by judicial construction or legislative enactment. The Petitioner should not be allowed to blow hot and cold at the same time—to apply the principle when it produces a taxpaying result and to refuse to apply the same principle when it does not produce a further taxpaying result. Here, Petitioner would require the group to abandon all right (so far as income tax laws are concerned) to recoup the in-

[1] 26 U.S.C. Sections 45, 141.
[2] Appendix, p. 50.

paired capital, and yet insists that all earnings shall fall into the common pot for dividend distribution purposes. Such a result is illogical and unjust and is contrary to convincing judicial precedent which originated, developed and applied the *Sansome* principle and to sound principles of income tax accounting.

The decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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APPENDIX

1. REVENUE ACT OF 1936, c. 690, 49 Stat. 1648:

Sec. 22. Gross Income.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

. . . . . .

Sec. 112. Recognition of Gain or Loss.

. . . . . .

(b) *Exchanges solely in kind.*—

. . . . . .

(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. . . .

. . . . . .

Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

. . . . . .

(15) *Property received by a corporation on complete liquidation of another.*—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112(b)(6), then the basis shall be the same as it would be in the hands of the transferor.

. . . . . .

Sec. 115. Distributions by Corporations.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203(a)(3)

and section 207(c)(1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113:

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in *another* corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

2 REVENUE ACT OF 1938, c. 289, 52 Stat. 447:

SEC. 115. Distributions by Corporations.

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1933, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

"(1) if no gain to such distributee from the receipt of such stock or securities, property, or money, was recognized by law; or

"(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution, or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

3. SECOND REVENUE ACT OF 1940, c. 757, 54 Stat. 974:

Sec. 501. Earnings and Profits of Corporations.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on earnings and profits of gain or loss and of receipt of tax-free distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis

(under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where, in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received."

(b) *Effective date of amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under prior Acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on September 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States. (26 U.S.C. 1940 ed., Sec. 115.)

4. TREASURY REGULATIONS 94, promulgated under the Revenue Act of 1936:—

Art. 115-3. *Earnings or profits.* In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

Art. 115-11. *Effect on earnings or profits of certain tax free exchanges and tax free distributions.* If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115(c) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of

stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1936, or on or after such date) in exchange for its stock or securities (see section 112(b)(3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

* * * * * * *

TREASURY REGULATIONS 101, (promulgated under the Revenue Act of 1938):

Art. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112(b)(6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall

be made, as between the transferor and transferee corporations.

The general rule provided in section 115(b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization —

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112(g) of the Revenue Act of 1932); or

(B) in any taxable year beginning before January 1, 1938 (or on or after such date) in exchange for its stock or securities (see section 112(b)(3)) if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under circumstances described in section 112(b)(6) of the Revenue Act of 1936 or section 112(b)(6) of the Revenue Act of 1938.

(3) The distribution in any taxable year (beginning after December 31, 1937) of stock or securities, or other property or money, in the case of an exchange or distribution described in section 374 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

* * * * * * *

6. INTERNAL REVENUE CODE, Sec. 129 (26 U.S.C. 1945 Ed., Sec. 129):

"*Sec. 129. Acquisitions made to evade or avoid income or excess profits tax*

(*a*) *Disallowance of deduction, credit, or allowance.* If (1) any person or persons acquire, on or after October 8, 1940, directly or indirectly, control of a corporation, or (2) any corporation acquires, on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately prior to such acquisition, by such acquiring corporation or its stockholders, the basis of which property in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income or excess profits tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For the purposes of clauses (1) and (2), control means the ownership of stock possessing at least 50 per centum of the total combined voting power of all classes of stock entitled to vote, or at least 50 per

centum of the total value of shares of all classes of stock of the corporation.

(b). Power of Commissioner to allow deduction, etc., in part. In any case to which subsection (a) is applicable the Commissioner is authorized

(1) to allow as a deduction, credit, or allowance any part of any amount disallowed by such subsection, if he determines that such allowance will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(2) to distribute, apportion, or allocate gross income; and distribute, apportion, or allocate the deductions, credits, or allowances the benefit of which was sought to be secured, between or among the corporations, or properties, or parts thereof, involved, and to allow such deductions, credits, or allowances so distributed, apportioned, or allocated, but to give effect to such allowance only to such extent as he determines will not result in the evasion or avoidance of Federal income and excess profits tax for which the acquisition was made; or

(3) to exercise his powers in part under paragraph (1) and in part under paragraph (2)."